

INVESTED CAPITAL ACCOUNTING

BEERS



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INVESTED CAPITAL ACCOUNTING

BASED ON THE INTERNAL REVENUE ACT OF 1918

By

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1922

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by

JAMES W. BEERS

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1922

Dedication

To

Hon. DAVID H. BLAIR, Commissioner of Internal Revenue;

E. H. BATSON, Deputy Commissioner of Internal
Revenue and Head of Income Tax Unit;

E. W. CHATTERTON, Assistant Deputy Commissioner
and Production Manager;

W. W. HUBERT, Assistant Production Manager;

B. E. HUNSINGER, Head, Staff Division, Income Tax Unit,

whose steadfast support of specialized training has constantly inspired in me a determination ever to do more to aid fellow employees to arrive at that stage of productive efficiency which has been so much desired by the officials of the Unit.

BETWEEN YOU AND ME

In days of long ago it was quite customary for an author to print in the forepart of his book the names of those who had subscribed for the work before issuance. That is a custom I should very much like to emulate, deeming it an honor to publish the names of the Income Tax enthusiasts who have made the publication of this book possible, but lack of space forbids.

This edition consists of one thousand copies. One thousand persons have each paid for a copy in advance of publication. More than that, not one of the thousand persons was asked to subscribe for the book—every subscription was voluntarily given. If any one, upon receipt of a copy, thinks that the subscription was ill-advised, he has only to return the copy to me and his money will be at once cheerfully returned to him. No subscriptions were received by the author—all was done independent of him. When it is realized that very few technical books approach a sale of a thousand copies, even after publication, it will be felt that this is a remarkable event in the world of books.

The advent of this book is unusual in other ways. It is received by the subscribers at actual cost of manufacture. The authorship rights are gladly donated for this issue with no thought that a second edition will at any time be printed. Not a penny of profit accrues to any one who has taken an interest in its production, and stranger still, no subscriptions were accepted from persons outside of the Income Tax Unit, notwithstanding the fact that many

persons expressed a desire to subscribe. No additional copies will be available—just enough are being printed to fill the advance subscriptions.

This book is in effect a second edition. The original edition bore the title of “Invested Capital and Excess Profits” and was put out in seven mimeographed pamphlets by the Training Section, Income Tax Unit. Thousands of copies were issued in this form to students in the Unit. That they were well received and proved beneficial is best evidenced by the fact that this re-written and enlarged edition is made possible by the voluntary cooperation of one thousand persons, practically all of whom received the mimeographed edition without cost.

The writing of those original pamphlets was a labor of love—but it was real labor. A new book may be written on nearly any subject that may come to mind. The writer, while his work may be original, constantly refers to predecessor publications for aid, suggestions, or guidance of some sort. But in the production of those pamphlets there was absolutely nothing that could be referred to, not a page in print, not a mimeographed sheet—nothing—absolutely nothing preceded them. Many questions had not yet come up for decision in the Unit and it required a good deal of courage to make some of the statements that were made in those texts relative to the computation of invested capital. It is gratifying to reflect that it has not been found necessary to change a single essential statement as it appeared in the original edition.

It is, perhaps, somewhat unusual for an author to give gratis a work, the writing of which involved many, many hours of his own time in his home—time he could have made good use of in other ways—when he had flattering offers from publishers to place it on the market. I just said “gratis,” but that is not correct; compensation has been received for it; a compensation that the teacher, in his innermost consciousness values more than money—the realization that he has produced something that is and has

been the means of helping others to do more work—and better work. That is my compensation, and it is satisfying.

I feel deeply grateful to fellow workers who have aided me—who with me groped their way through the dark, looking for light at a time when there was no light, and who with me created such light as now is.

In particular do I wish to thank Mr. Edwin D. Evans, C. P. A., of the Consolidated Review Section, Natural Resources Division, for his review of my original manuscript and for his helpful suggestions. To Mr. John M. Hartman, Assistant Chief of the Training Section, I extend my thanks for the privilege of including in this book Chapters Three and Four. To Mr. Hugh L. Ducker, B. C. S., Chief, Technical Subsection, Training Section, and Mr. Ralph D. Toll, Assistant Chief, Technical Subsection, Training Section, I wish to express my appreciation of their labors in reading the entire proof, checking up all of the computations, and for valuable textual suggestions.

Just a word in my own behalf. It may be thought by some that the writing of the "Invested Capital and Excess Profits" texts naturally devolved upon me as a part of my duties as Chief of the Training Section. To correct any such misapprehension it is only necessary to state that the texts were written before I became Chief of Training Section—before holding any official position—even before dreaming that I would ever hold such a position. I had entered the Unit at that early date when there were no helps available and I had the same hard struggle to master the intricacies of invested capital that others had. Being a teacher, I wanted to help others—that was the primal cause of the appearance of the original issues, and I have been actuated only by the same desire in sacrificing my own time to put forth this enlarged and more presentable edition.

JAMES W. BEERS.

Washington, D. C.

November 15, 1922.

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CHAPTER ONE

FUNDAMENTALS

Foreword

In writing this book no effort will be made to follow the order of the Articles as given in the Regulations. It is thought better to present the matter by topics, so far as is possible, treating each topic, or group of topics as a unit. Neither shall Regulations be quoted to any extent; I have a feeling that students are looking for something in these pages that they do not find in Regulations—otherwise the necessity for this work is not apparent. If the language employed seems sometimes vague or ambiguous, lay the blame to the fact that the author is blazing a new trail. Were he to write a text on accounting or on chemistry, or on any one of dozens of other subjects, there are hundreds of books to which he could refer and from which he could obtain help. In the present case there is nothing to which access can be had except Regulations and the Bulletins, and you already have them. The task is to create a new book—no one in the Income Tax Unit has yet had the courage or the hardihood to do it—and in the creation of it doubtless you will find evidences of shortcomings, for which your indulgence is craved.

The Scope of These Texts

No dissertation on the history of corporations or on the reasons for incorporating or on the economic effects of income tax will be given; neither is the text matter, nor the illustrations presented to be considered as models of

accounting technique. The primary object is to teach tax law and tax law accounting; not general accounting. The sole aim is to present to you things vital in your work—in other words we shall endeavor to get right down to fundamentals at once.

Originally it was intended to present only a revision of the series known as "Excess Profits and Invested Capital," but many persons have suggested the advisability of including in this book the author's several texts on "Corporation Tax Law." The logical place for these is, of course, in the front of the book. Those who wish to study only "Invested Capital Accounting" may do so by skipping the first six chapters and beginning the study at Chapter Seven.

All we have to deal with here is the effect of the 1918 Income Tax Law as it affects corporations—what corporations are taxable, and why, and the methods of arriving at the correct amount of tax in any given case, and this brings us down to the question—

What is a Corporation?

Under the corporation laws of the various states a corporation is a legal entity; that is, a thing complete within itself—an artificial person created by law. It can sue and be sued; acquire and sell property; can make contracts and perform such other activities as come within the provisions of its charter.

Blackstone says:

"A corporation is an artificial person created for preserving in perpetual succession certain rights which being conferred on natural persons only would fail in the process of time."

Chief Justice Marshall has given us a definition from a more modern viewpoint, as follows:

"An artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created."

The assets of a corporation belong to the corporation and not to the stockholders. A person who turns property over to a corporation forfeits all direct control of the property. He has no more right to it than he would have, had some one else owned the property. It is no longer his. If a stockholder were to appropriate corporation property to his own use, he would as certainly be guilty of larceny (in the eyes of law) as would be a person who has no connection with, or interest in the concern. The only way he can exercise any control over such property or over any other property acquired by a corporation or any possession of a corporation is through the board of directors. This board acts for the corporation on precisely the same basis as you act for yourself in the acquirement, the disposition of, or the use of your own property.

Kinds of Corporations

Common law places corporations in two classes: Public corporations and private corporations.

A town incorporates and becomes a borough or a city; that is a public corporation.

Several men unite in some business enterprise and file application with the secretary of some state for a char-

ter to permit them to conduct a certain line or certain lines of business under a specific name at some definite place or places. That is a private corporation.

Private corporations are subdivided into public service corporations and business corporations. A public service corporation is one dealing in some commodity necessary to the public, as a water company, a street car company, or a gas company.

But in income tax procedure, while in the main these classifications obtain, corporations are classified slightly different in some respects. We have eleemosynary corporations, and business corporations, personal service corporations, and corporations doing a part personal service business.

(When a number of men unite in some enterprise, they are commonly referred to as a "firm," but when the corporate form is adopted, it is often spoken of as the "company." The use of these words in this manner is not universal, inasmuch as we occasionally hear of a partnership, as well as a corporation, referred to as a company, as, for example, John Jones & Co. might be a partnership or it might be a corporation. The word "firm," however, should never be used in connection with a corporation. Of course, if "Inc.," or "Incorporated" is a part of the name, we know that the concern is not a partnership; that it is a corporation. Frequently the name does include "Incorporated" in full or abbreviated, but inasmuch as its inclusion is not always obligatory, the custom is far from universal.)

An eleemosynary corporation is one devoted to charity, and, so long as no profit inures to any individual connected with it, it is not subject to tax.

For tax purposes we may expand the meaning of

eleemosynary to include a number of other corporations, such as those devoted to educational purposes, or to religious work, or to scientific matters, or to societies operated for the prevention of cruelty to children or animals.

You will note that all of the above may be embraced in a common class—all, when operated without profit to any stockholder or individual, may be classed as corporations organized and conducted for the uplift or betterment of social conditions.

To this class, in so far as tax is concerned, is added a number of corporations conducted for various purposes, that, in a sense, might be called business corporations, but which we must omit from that class. Such corporate organizations as boards of trade, business leagues, civic organizations, chambers of commerce, county fairs, cemetery companies, etc., are not taxable, provided, that they stand the test: The conduction must be such that no person received or can receive any share of the net earnings by virtue of his connection with the organization.

Another line of organizations that are non-taxable (provided they qualify under the above test) is social clubs, athletic clubs, literary societies, scientific or technical societies, labor organizations, and other societies organized solely for pleasure, recreation, amusement or for any activity not conducted for profit.

Still another class is mutual insurance companies, mutual telephone companies, mutual irrigation companies; lodges whether or not they are beneficiary in character. There are both kinds—the Maccabees are obligated to pay benefits, while some other fraternal organizations are not so obligated.

Then there is the other “mutual class”—building and loan associations, mutual savings banks and cooperative banks (provided no capital stock is represented by shares),

associations formed by fruit growers, farmers, etc., conducted as a sales agency and the income from which is distributed on the basis of the *quantity* of produce turned over to the association for disposal.

It should be observed that all of these come down to a single proposition—the matter of distributable profits. The question is, “Does, or could, this corporation have net income any part of which would inure to any stockholder, member, or individual?” If it does, or could, it is taxable the same as are other taxable corporations; if not, then it is placed in the non-taxable class.

It is suggested that you study Section 231 of the 1918 Revenue Law, and, also, Article 511 of the Regulations relating to “Proof of Exemption,” and Article 517 of the Regulations relating to eleemosynary corporations. A close reading of Articles beginning with 512 and ending with 522 is advisable.

Another Classification

Then we have corporations classified as Domestic Corporations and Foreign Corporations. A Domestic Corporation is one operating under the laws of any one of the forty-eight States of the American Union, or of the District of Columbia, or of one of the territories, Alaska and Hawaii. All others are Foreign Corporations. Right here is a confusion of terms. The national, or income tax view and use of the terms “domestic” and “foreign” is in harmony with the above definition. The viewpoint of a state official is this: A corporation organized under the laws of his state is a domestic corporation; all others are foreign corporations. Thus, a corporation organized under the laws of Pennsylvania and doing business in New York State is regarded in New York as a foreign corporation. You must use the term in its broad, national aspect; not in the restricted state sense.

Corporation Shares—Definitions

The proprietary interest in a corporation is represented by shares, or stock certificates, commonly called "stock" and broadly subdivided into "Common Stock" and "Preferred Stock." These divisions are often further divided into other classes as First Preferred, Second Preferred, etc., but these secondary divisions have no interest for us except from the viewpoint of accountancy. In fact, it is but seldom that, for tax purposes, we find it necessary to make separate classifications of stock even as to Common and Preferred.

The matter of stock nomenclature is pretty thoroughly covered in the chapters devoted to Excess Profits Accounting, and it is in the computation of Excess Profits tax that we find most use for such knowledge. However, since this chapter is one of the steps leading up to Excess Profits work, it seems fitting that a brief description be here given covering certain classes of stock.

Common stock is most usual. All of the shares of a corporation may be Common, or some of it may be Preferred. If there be Preferred Stock there must of necessity be Common Stock.

Broadly speaking the difference between Common and Preferred is that in case of dividends the Preferred comes first. Preferred Stock receives a specific dividend percentage rate. In the event that the amount available for dividends is insufficient to "go around" the holders of Preferred get the dividend; the holders of Common do not. Preferred Stock may be cumulative or non-cumulative, but these features are thoroughly covered in the Accounting Course of the Income Tax Unit. Common Stock usually carries voting rights, and in some instances is a better investment than Preferred Stock.

Then we have Issued Stock and Unissued Stock. It would seem unnecessary to describe these terms, but unfortunately, such is not the case. Unissued Stock is stock that has not been sold, and must never be termed Treasury Stock. Issued Stock is stock that is or was sold or parted with by the corporation. If some (or all) of this stock (the Issued Stock) was bought back by the corporation, or if it was returned to the corporation as a gift, it then ceases to be outstanding stock but has become Treasury Stock. Note carefully, exactly what is Treasury Stock. You will find the information useful later on.

Determining Net Income from the Balance Sheet

A corporation reports a net taxable income for 1919 amounting to \$105,000 and submits the following Balance Sheets:

<i>Assets:</i>	<i>Dec. 31, 1918</i>	<i>Dec. 31, 1919</i>
Cash	\$30,000	\$35,000
Accounts Receivable.....	20,000	15,000
Sundry Assets.....	300,000	350,000
	<u>\$350,000</u>	<u>\$400,000</u>
<i>Liabilities and Capital:</i>		
Sundry Liabilities.....	\$40,000	\$21,000
Allowance for bad debts.....	6,000	10,000
Reserve for Plant Extension.....	15,000	30,000
Surplus	89,000	139,000
Capital Stock.....	200,000	200,000
	<u>\$350,000</u>	<u>\$400,000</u>

It reports that a dividend of \$50,000 was declared and paid December 10, 1919, and that a \$5,000 donation made

to the Salvation Army was charged to Profit and Loss. (Had this item been a charge to Surplus it would not affect our computation since we are arriving at net taxable income from the Balance Sheets, not from the Profit and Loss Statement.)

Upon investigation we find no other unallowable deductions except \$20,000 income tax paid for 1918. We find that—

Surplus at the end of the year exceeds surplus at the beginning of the year by.....	\$50,000
Dividends paid	50,000
<hr/>	
Apparent total increase in value.....	\$100,000
Plus unallowable items (donations).....	5,000
<hr/>	
Taxable income as reported.....	<u>\$105,000</u>

Is this amount (\$105,000) the correct taxable income? No, though it doubtless would so appear to the stockholders who are prone to look upon the amount received in dividends plus the increase in Surplus as typifying the net earnings.

To the \$105,000 must be added the 1918 income tax paid in 1919 making a taxable income of \$125,000.

Have we now arrived at the taxable net income? We have not. In income tax procedure and with one or two exceptions in accepted accounting practice, charges to Surplus items which are not deductible are only surplus under other names set apart for a specific purpose.

In computing net income under the 1918 tax law, taxpayers are not permitted to deduct any amount for possible future losses arising from bad debts. Only such an amount may be deducted as has actually been determined to be

worthless during the taxable year and which has been charged off.

In the proposition before us, we find that at the beginning of the year the balance sheet carried a Bad Debt Allowance of \$6,000 and at the end of the year, this Allowance is increased to \$10,000 so we must add \$4,000 more to the taxable income. It matters not that this \$4,000 may prove worthless during the coming year and that there is every reason to believe that it will so prove. This is one of the instances in which income tax procedure diverges from accepted accounting practice, for the public accountant probably would make a charge to Profit and Loss of \$4,000. The tax accountant must not do so. You will readily perceive, of course, that if this allowance had not been increased that Surplus would have been \$4,000 greater; the increase being brought about by an entry something like this:

Profit and Loss.....	\$4,000
Allowance for Bad Debts.....	\$4,000
(Appropriate Explanation)	

Also we find that Reserve for Plant Extension has been increased by \$15,000, which amount is nothing but allocated surplus and must be added to the taxable income. If this amount had already been expended for necessary repairs, the reduction in net income would be reflected through Profit and Loss, but this particular reserve is set up for future use. If this amount had been expended in the past (or if expended in the future) for additions and betterments, this reserve would disappear and Surplus would be increased by a like amount brought about by entries something like the following:

Reserve for Plant Extension.....	\$15,000
Cash (or Accounts Payable).....	\$15,000
(Explanation)	
Plant	\$15,000
Surplus	\$15,000
(Explanation)	

You will note from this that all additions to the reserves that are not deductible from gross income in arriving at net taxable income must be added back to Surplus to get the taxable income from the balance sheets.

You will also note that taxable net income is usually greater than the actual book income although it might be less as we shall see later on. In this proposition the actual book income is \$119,000 while the taxable income is \$144,000.

Limited Partnerships

Some limited partnerships are, in effect, corporations, and should be taxed as such. Others, termed "limited partnerships" by the various statutes of the several states authorizing such combinations of individuals engaged in business, are nothing more than ordinary or common law partnerships. To determine whether any of the so-called limited partnerships are to be given a status of corporations for income and excess profits tax purposes, or are to be taxed through the individuals composing them (or, under the 1917 Revenue Act, as partnerships), knowledge must be had of the nature of the statute under which they are created and the scope of the powers and limitations granted them.

In some states, notably Pennsylvania, a form of limited partnership is found, which, to all intents and purposes, is a corporate form of business organization. The liability of the partners is restricted to certain definite limitations,

shares are issued and may be transferred without affecting the business. The death of a partner does not dissolve the business. They may sue and be sued, and, generally, exercise most of the prerogatives of an ordinary corporation.

However, simply because a state law provides for the formation of a partnership form of organization like, or similar to, the form in vogue in Pennsylvania, does not imply that all partnerships in that state are limited. In Pennsylvania, for instance, are to be found many partnerships that do not have any semblance to the corporate form of organization.

These will be found to be only common law partnerships. In some states provision is made for a limited form of partnership in which only a certain class or division of the persons composing the organization enjoy the liability limitation, while the general partners are not immune from liability to the creditors of the concern. Such partnerships are to be classed as ordinary partnerships.

The following are the chief factors that determine that a partnership is not to be taxed as a corporation:

1. If death of a member dissolves the partnership.
2. If shares are not issued, or if an interest in the partnership be not subject to transfer at the discretion of a partner.
3. If liability to creditors be not limited.
4. If title to real estate cannot be taken or given in the partnership name.
5. If the partnership cannot sue or be sued.

Generally speaking, any provisions in a partnership organization which would be the opposite in effect from the above conditions would be good grounds for classing

the partnership as coming within the corporate form and for taxing it as a corporation.

Partnerships Changing to Corporation

Study Article 933. You will note from this article that a capitalistic corporation organized prior to July 1, 1919, that is a successor to a business previously conducted as a partnership, or by an individual, may elect to be taxed as a corporation from January 1, 1918, provided its net income for the taxable year 1918 is equal to or exceeds 20 per cent of its invested capital. When you arrive at the Invested Capital Accounting section of this book you will be fully advised as to what constitutes invested capital and how the amount is determined.

Misleading Profit and Loss Statements

That a Profit and Loss statement may reveal a certain amount of net income is not necessarily indicative that the amount revealed is the net taxable income. The cardinal reasons for this are:

1. Items may have been charged to Profit and Loss through Expense Account that should have been capitalized. Thus, the cost of a machine might be charged to Expense, inadvertently or otherwise, and the net profit indicated by the Profit and Loss Statement would be less than it should be to the amount of the cost of the machine. We occasionally see organization expenses charged to Expense; such expenses should be capitalized.

It is sometimes found that the total discount on bonds has been charged to Profit and Loss at the time of issue.

Let us say that ten-year bonds, face value \$10,000, are sold for \$9,000. Each year during the

life of the bonds \$100 should be charged to Profit and Loss. To do otherwise is to charge the current year with an expense incurred for future years, and, in the case of some corporations, this might operate to show a loss for the first year, when, in fact, there was an actual profit. You understand, of course, that discount on bonds is, in effect, additional interest.

Analytic examination of Expense Accounts is one of the most fruitful sources of additional net income. The auditor who accepts a taxpayer's Profit and Loss Statement without question, especially if expense amounts seem out of proportion to the volume of business done, is not performing his full duty.

The cost of installing new machinery is a capital expenditure; not an allowable deduction.

Items such as the following should not be charged to Profit and Loss, directly or indirectly, as all such expenses (so-called) represent capital outlay, and, as more fully explained in the chapters on Invested Capital Accounting constitute a part of the concern's invested capital:

- (a) Cost of installing new machinery, and engineer's drawings, etc., used in connection therewith.
- (b) Architectural drawings and supervision of new construction.
- (c) Surveys, maps, plats, etc., necessary in connection with the acquirement of realty.

In a broad sense, any expenditure necessary in connection with the acquirement of an asset is a part of the cost of the asset and should be capitalized as such, while any expenditure incidental to the upkeep of the asset should be a charge to Profit and Loss through an appropriate Ex-

pense Account. This matter is more fully covered in a subsequent chapter; the accounting technique required is explained in the Accounting Course of the Income Tax Unit.

To illustrate the above: The California Wine Co., purchased in France, a big wine press; cost in France on board boat, \$10,000. Ocean freight, \$1,000; import duty, \$3,000; brokerage, \$100; freight from New York to California, \$1,000; cartage from freight house to plant, \$500; engineer's plans for and supervision of installation, \$200; labor of installing, \$300. All of these items are capital expenditures; none should be charged to Expense. Total amount to be capitalized is \$16,100.

2. Profit and Loss may have been credited with earned or partly earned profits that are not taxable or that should be taxed over a period of years. For instance, a concern issues \$10,000 face value bonds and sells them for \$11,000. The bookkeeper or the management may look upon the extra \$1,000 as profit and credit it to Profit and Loss. This is incorrect practice. The \$1,000 should be amortized over the life of the bonds. Assuming the life of the above bonds to be ten years, \$100 only should have been credited to Profit and Loss. (The matter of bonds is covered in a subsequent chapter.) Or, it may have sold Treasury Stock at a price greater than the cost price to the corporation and the difference may have been credited to Profit and Loss. This would be non-taxable income. See Article 542.
3. Items may have been capitalized which should have been charged to Profit and Loss through an Expense Account. This would tend to show a greater net income than actually was earned. To illustrate: Tools having a life of one year or less

should be charged to Expense—not to Plant, or to Equipment; Patterns or molds made for a special job, or whose apparent usefulness is but temporary, should be charged to Expense, while other patterns or molds should be capitalized. Advertising is another item, much of which falls within this class. It may be true, as contended by some, that all advertising tends to build up goodwill; that point we do not care to discuss. As a matter of fact, the great bulk of advertising is a current expense, pure and simple, and is a proper charge to Selling Expense.

4. Items may have been charged to Profit and Loss in an incorrect amount. Thus, if excessive depreciation is charged, the net income is understated; if charged at too low a rate, the net income is overstated.
5. Items may have been charged to Profit and Loss, which from long established procedure, is considered good practice, but which, in income tax procedure, are not allowable deductions from gross income. To cite an example: A concern may hold a lot of commercial paper (promissory notes) and feels that some of it will prove uncollectible, hence it charges a percentage of the total to Profit and Loss. This is good, conservative practice, and is followed by good accountants, but in determining net taxable income it is an unallowable deduction. Another item belonging to this class of deductions is income, excess profits and war profits taxes, which are not deductible items, although they do reduce the taxpayer's net income available for distribution or for investment.

Reconciliation of Surplus

The following "balance" or equation must always be present:

$$\begin{array}{l}
 \text{Total Surplus at the be-} \\
 \text{ginning of the year} \\
 \text{PLUS the year's earnings} \\
 \text{PLUS other credits to} \\
 \text{Surplus}
 \end{array}
 \left. \vphantom{\begin{array}{l} \text{Total Surplus at the be-} \\ \text{ginning of the year} \\ \text{PLUS the year's earnings} \\ \text{PLUS other credits to} \\ \text{Surplus} \end{array}} \right\} \begin{array}{c} \text{must} \\ \text{exactly} \\ \text{balance} \\ \text{with} \end{array} \left\{ \begin{array}{l} \text{Total Surplus at the end} \\ \text{of the year} \\ \text{PLUS Dividends paid dur-} \\ \text{ing the year} \\ \text{PLUS other charges to} \\ \text{Surplus} \end{array} \right.$$

Or, to put it in another way—

$$\begin{array}{l}
 \text{Total Surplus at the be-} \\
 \text{ginning of the year} \\
 \text{PLUS the year's} \\
 \text{earnings} \\
 \text{PLUS other credits to} \\
 \text{Surplus}
 \end{array}
 \left. \vphantom{\begin{array}{l} \text{Total Surplus at the be-} \\ \text{ginning of the year} \\ \text{PLUS the year's} \\ \text{earnings} \\ \text{PLUS other credits to} \\ \text{Surplus} \end{array}} \right\} \begin{array}{c} \text{minus} \\ \\ \\ \\ \end{array} \left\{ \begin{array}{l} \text{Dividends paid} \\ \text{during the} \\ \text{year, and other} \\ \text{charges to} \\ \text{Surplus} \end{array} \right\} \begin{array}{c} \text{should} \\ \text{equal} \\ \text{the} \end{array} \left\{ \begin{array}{l} \text{Total Sur-} \\ \text{plus shown} \\ \text{by the books} \\ \text{at the end} \\ \text{of the year} \end{array} \right.$$

Note: By "Total Surplus" is meant all items that are real surplus, whether they be called "Undivided Profits," or under any one of the numerous names given Reserves that are actual reserves, as, to cite: Reserve for Contingencies, or Improvements, or other similar items, appropriately designated "Allocated Surplus." A "true reserve," or Allocated Surplus is real surplus set up under a different name by making a Journal entry charging Surplus and crediting the Reserve, as:

Surplus	\$5,000
Reserve for New Machinery.....	\$5,000
(Appropriate Explanation)	

Let us see what this sometimes proves. Certain abridged Balance Sheets disclose the following:

<i>Assets:</i>	<i>Dec. 31, 1918</i>	<i>Dec. 31, 1919</i>
Cash	\$5,000	\$50,000
Plant	100,000	120,000
Inventory	70,000	73,000
Receivables	35,000	32,000
	<u>\$210,000</u>	<u>\$275,000</u>
<i>Liabilities and Capital:</i>	<i>Dec. 31, 1918</i>	<i>Dec. 31, 1919</i>
Capital Stock.....	\$75,000	\$75,000
Surplus	65,000	65,000
Undivided Profits.....	15,000	55,000
Allocated Surplus (True Reserves).....	35,000	50,000
Notes Payable.....	20,000	30,000
	<u>\$210,000</u>	<u>\$275,000</u>

This concern reports a net taxable income of \$103,000; dividends paid \$40,000; income tax \$15,000; donations \$5,000; credit to surplus of \$2,000 profit on the sale of Treasury Stock.

Will the statement reconcile? Let us see—

Surplus and Undivided Profits at the beginning of the year.....		\$80,000
Allocated Surplus (True Reserves).....		35,000
Earnings as reported.....		103,000
Other credits to Surplus.....		2,000
		<u>\$220,000</u>
Less: Dividends paid.....	\$40,000	
Allocated Surplus (True Reserves).....	50,000	
Income Tax.....	15,000	
Donations	5,000	110,000
		<u>\$110,000</u>

Surplus does not reconcile in this proposition.

On the basis of the taxpayer's statement the books should show a Surplus of \$110,000 at the end of the year, but we find that the Balance Sheet reveals \$120,000. (Surplus and Undivided Profits.) It is certain that the taxpayer's statement is incorrect or there is an error in the Balance Sheets. In such cases it is the auditor's duty to locate the error. If that can not be done by the aid of the information at hand, the taxpayer should be requested to explain. In the above proposition apparently taxable income is understated by \$10,000.

You will see from the above that the attempted reconciliation proves the existence of an error. It cannot be too strongly impressed upon you the fact that reconciliation of Surplus and Undivided Profits is the signboard that points the way to correct determination of net income. If you are weak in this phase of tax procedure, you are earnestly advised to make a special study of the subject at once.

But note this particularly: Surplus may reconcile to a cent; the Balance Sheets may be absolutely correct, but if donations and income and excess profits taxes have been charged to Expense or direct to Profit and Loss or to Surplus you must add such amounts to the net income that has been revealed by a comparison of the Balance Sheets as at the beginning and as at the end of the taxable period.

Income Tax Computation

As will be seen from Article 502, before computing the income tax, certain credits are allowed which reduce the taxable income. The chief credits are:

- (a) An exemption of \$2,000, which, in the case of

a domestic corporation, is free from tax. Foreign corporations do not enjoy this exemption. See Article 591.

(b) The amount of excess profits tax and war profits tax of the taxable year, is a credit. Since excess profits tax is completely covered in a subsequent chapter no computation in that respect will be required at present. The several propositions will state the amount of excess profits and war profits taxes.

(c) Interest received upon obligations of the United States and from bonds issued by the War Finance Corporation if any such interest has been included in gross income, should be deducted.

You must distinguish clearly between "income tax" and "excess profits tax." The former is the tax on income; the latter is not a tax on income but is a tax on abnormal or "excess" profits with relation to the amount of capital invested in the business.

The proper procedure is: First, after arriving at true net income, deduct \$2,000 (if a domestic corporation). The balance, if there be no profits taxes, is taxable at the rate of 12% in 1918 and 10% in subsequent years.

Let us assume that the Keenedge Cutlery Company had a net income in 1918 of \$8,000. We will further assume that its invested capital is such as to eliminate all profits taxes. For 1918 its income tax would be 12% of (\$8,000—\$2,000), or \$720. For 1919 its tax would be (basing on \$8,000 net income) 10% of (\$8,000—\$2,000), or \$600.

Now let us assume that this corporation had an income of \$20,000 for 1918 and \$25,000 for 1919. Also that the profits tax for 1918 is \$8,000 and for 1919 it is \$10,000. (The method of determining profits taxes will be presented later.) Again we will assume that it receives \$300 interest

from obligations of the United States in each of the years named and which is not subject to tax.

The tax will be computed as follows: (The numbers beginning with each line correspond with the numbers in Schedule IV of the return Form 1120.)

12. Net income for taxable year (1918).....	\$20,000
13. Less interest on obligations of the U. S. . . \$300	
14. Less profits tax.....	8,000
15. Less exemption.....	2,000
	<hr/>
16. Amount subject to income tax.....	9,700
	<hr/>
17. Tax of 12% on Item 16.....	1,164
18. Profits tax.....	8,000
	<hr/>
20. Total tax.....	<u>\$9,164</u>

For 1919 the computation would differ only in amounts and rate—

Profits Tax (Schedule D).....	\$10,000
5. Net income for taxable year.....	\$25,000
6. Less interest on obligations of the U. S.	\$300
7. Less profits tax.....	10,000
9. Less exemption.....	2,000
	<hr/>
10. Amount subject to income tax....	\$12,700
11. Tax of 10% on item 10.....	1,270
	<hr/>
12. Total tax.....	<u>\$11,270</u>

Fiscal Year

The foregoing computations are on the calendar year basis. Now let us assume that this company keeps its

books on a fiscal year basis that begins September 1, 1918, and ends August 31, 1919, of the next year, and that for the fiscal year the net income was \$40,000. The total war and excess profits taxes computed under the 1918 law, we assume to be \$36,000, of which the amount applicable to that portion of the year included in 1918 is four-twelfths or \$12,000. The total profits tax computed under the 1919 law we assume to be \$30,000, of which the amount applicable to that portion of the year included in 1919 is eight-twelfths or \$20,000.

Of course, it is clear to you that in such event the proportionate part of the tax applicable to the calendar year 1918 must be added to the proportionate part of the tax applicable to the calendar year 1919 in order to obtain the total war and excess profits taxes for the fiscal year.

The proposition is: How should we determine the correct amount of tax liability of a corporation that files its return on a fiscal year basis? The procedure is as follows:

Ascertain the correct profits taxes by making two complete tax computations, one on the basis of the 1918 tax law and one on the 1919 tax law and take that portion of the tax for each year as the number of months in each calendar year is of the entire period. These two amounts added together will give the total profits taxes for the fiscal year.

The income tax is obtained by taking the net income for the taxable year, less the specific exemptions, computed on the basis of the rates for each year and taking that proportion of the total for 1918 which the number of months is of the number of months in the period and that proportion of the total for 1919 which the number of months is of the number of months in the period. These two amounts added together give the total income tax for the period.

The Proposition Illustrated

Summary of War and Excess Profits Taxes

Total war and excess profits taxes applicable to the calendar year 1918.....	\$12,000
Total excess profits tax applicable to the calendar year 1919..	20,000
Total war and excess profits taxes.....	<u>\$32,000</u>

Computation of Income Tax

16. Net income for the fiscal year.....		\$40,000
18. Less: War and excess profits taxes.....	\$32,000	
19. Exemption	2,000	34,000
20. Balance subject to income tax.....		<u>\$6,000</u>
21. Tax of 12% (1918 law).....	720	
22. Tax of 10% (1919 law).....	600	
23. Inasmuch as four months of the fiscal year come in the calendar year 1918, the portion of the tax applicable to 1918 is four-twelfths of \$720 or.....		240
24. Inasmuch as eight months of the fiscal year come in the calendar year 1919, the portion of the tax applicable to 1919 is eight-twelfths of \$600 or.....		400
25. Total income tax.....		<u>\$640</u>

Summary

26. War and excess profits tax.....	\$32,000
27. Income tax.....	640
30. Total tax.....	<u>\$32,640</u>

A fiscal year beginning in 1919 and ending in 1920 would be computed but once—just the same as it would be computed were it a calendar year, for the reason that the rates for 1919 and 1920 are the same. This same

procedure will hold good just so long in the future as the 1918 income and excess profits tax rates remain, unchanged.

Part of a Year

In the event that a corporation files a return for part of a year as when a change is made from a fiscal year basis to a calendar year basis, the \$2,000 exemption should be prorated.

Thus if the Keenedge Cutlery Company had been filing returns on the fiscal year basis as at August 31, and it had been decided to change to the calendar year basis, a return would be filed for the four months period ended December 31, 1919. In its return for the yearly period ended August 31, 1919, it took advantage of the \$2,000 exemption, hence $\frac{2}{3}$ of the \$2,000 is reflected in that return. For the four-months period, exemption must be reduced to the number 12ths of \$2,000 that is equal to the numbers of months embraced in the part-year period; in this case $\frac{4}{12}$ exemption being \$666.67.

CHAPTER TWO

GROSS INCOME—DEDUCTIONS—NET INCOME

In accounting parlance, income (disregarding for the time being the terms "gross income" and "net income") is usually divided into three classes—operating income, non-operating income, and financial income.

Operating income is income derived through the regular course of business. Thus, a manufacturer of furniture sells a dozen chairs. The receipts from the chairs is operating income.

Non-operating income may be derived from the sale of a capital asset at a price above its worth or above its cost. Thus, someone may wish to conduct a restaurant on a corner lot owned by the manufacturer which adjoins the factory, and, owing to its proximity to many workers, the party is willing to pay a big price for it. The taxpayer may sell some securities which have been held pending a rise in the market. The profit derived from these and similar transactions would be non-operating income.

Financial income may be derived in a number of ways. The manufacturer referred to may lend some money at interest. The interest accrued or received would be financial income.

By the way, a great many persons, more or less educated, would have used the word "loan" in the above sentence in place of "lend." Such usage is not good. "Loan" is employed only as a noun in the best English.

Apropos of correct English, here is a list of

words almost universally mispronounced. In each of the following words give the "a" in the accented syllable the long sound of the vowel, as heard in "same":

Dā-ta	Grā-tis	Pro-rā-ta
Dā-tum	Ap-pa-rā-tus	Er-rā-ta
Stā-tus	Ig-no-rā-mus	Er-rā-tum

Note the following:

Finance; short i as in fin; accent on the second syllable.

Financial; short i as in fin; accent on the second syllable.

Financier; short i as in fin; accent on the last syllable; pronounced fi-nan-seer.

Amortize; accent on the second syllable.

Amortization; primary accent on the fourth syllable; secondary accent on the second syllable.

Now, while the various classes of income should always be segregated in books of account, not permitting non-operating profits, or any profits not directly the result of regular business operations to appear as a credit to Profit and Loss we in the audit are not particularly interested in the matter of what account is credited with the income, but we are intensely interested in the question—"Is this income taxable?" So we classify all income, first as "Gross Income," and "Net Income," and subdivide the latter into "taxable" income and "non-taxable" income.

Gross Income

In a sense "gross income" is synonymous with "gross profits," as revealed by a trading statement, and from that amount certain deductions, termed roughly "operating ex-

penses," are taken, which gives us "net profit," or "net income."

To make it clearer, a merchant sells a stove for \$50. The \$50 is not income or "gross income" for at least a part of that \$50 represents only transformation of capital. Assuming that the stove cost the merchant \$50, the transaction to that extent only indicates that the merchant exchanged one stove (a part of his capital) for \$50, in Cash, Accounts Receivable, or Notes Receivable, and whatever it was that he received for the stove is still capital but changed in nature. The \$50 is not income of any kind.

But let us assume that this merchant sold during the year a lot of stoves (or other goods) and that he sold, or aimed to sell, them at a profit. He had goods on hand at the beginning of the year, and since he was not retiring from business, he had goods on hand at the end of the year. If he had marked each item at its exact cost, and each time he made a sale he credited a Profit Account with the difference between the cost of the goods and the selling price, he would at the end of the year be able to ascertain his gross profit by adding up the profit items and deducting from that amount the losses, if any goods had been sold below cost. But such a scheme is not practical. Many items are purchased by the merchant by the dozen, or in other quantitative lots, and the unit cost of each item is expressed in odd cents, or a fraction of a cent. Besides, the labor of keeping such records would be monumental, and the time required to make such records at the time of the sale would be so great that additional clerks would be required, and every clerk would of necessity have to know just how much the merchant made on a sale. That would be very undesirable, and the chances of error would be greatly multiplied.

The customary and best way to arrive at the desired result is by the inventory method. At January 1, this mer-

chant had, let us say, \$35,000 worth of goods on hand. That is his opening inventory. The ledger shows that during the year Purchases were charged with \$65,000, Sales Account is credited with \$93,000 during the year, and at December 31 an inventory is taken, showing \$38,000 worth of goods on hand. That is his closing inventory.

By setting up a simple Trading Statement we readily arrive at Gross Profit—

Opening Inventory.....	\$35,000	Sales	\$93,000
Purchases.....	65,000	Closing Inventory	38,000
Gross Profit			
(To profit and loss) ..	31,000		
	<u>\$131,000</u>		<u>\$131,000</u>

Of course, in practice, other accounts would enter into the above, as Freight, Return Sales, Return Purchases, etc. Our aim is not to teach accounting in this series, but to teach tax law, bringing in accounting features only to the extent necessary to illustrate and explain the law and its application.

The above \$31,000 represents the Gross Profit, but what we are after is the Net Profit. In selling these goods certain expenses were incurred, and all of these expenses must be deducted before we find Net Profit, the amount that would ordinarily be carried to Surplus. Hence we have recourse to the Profit and Loss Statement. Gross Profit is a credit balance in the Trading Account, and when carried to Profit and Loss, thus—

Trading	\$31,000
Profit and Loss.....	\$31,000
(Suitable explanation)	

The Trading Account is closed out, and we have a credit of \$31,000 to the—

Profit and Loss Statement

Wages and Salaries.....	\$6,000	Gross Profit from	
Rent.....	2,400	Trading	\$31,000
Insurance	1,000		
Bad Debts charged off ..	500		
Interest paid (or accrued)	100		
General Expense.....	2,000		
Net Profit, (carried down)	19,000		
	<u>\$31,000</u>		<u>\$31,000</u>
		Net profit carried to	
		Surplus	\$19,000

There are allowed as deductions all the necessary expenses of doing business, which may embrace many items not given in our Profit and Loss Statement. Doubtless you have been through the course on Individual Tax Law, and have made a study of deductions. Almost the same deductions are allowed corporations as are permitted individuals. A notable exception is Donations, which the individual may deduct (to a limited extent), and the corporation may not deduct to any extent. One deduction is allowed corporations that an individual may not take—dividends received from other taxable corporations. Special deductions are allowed insurance companies, but that matter will not be taken up here.

In the problem just presented we find the net income to be \$19,000. As stated in another chapter, an exemption of \$2,000 is allowed, leaving in this instance a net taxable income of \$17,000. We did not charge Profit and Loss with depreciation inasmuch as inventories may not be depre-

ciated, and nothing enters into the problem but goods. If, however, this taxpayer had depreciable property, such as a building, delivery trucks, furniture and fixtures, Profit and Loss should be charged with the usual amount of depreciation for the year. The question of depreciation will not be treated to any great extent in this chapter, inasmuch as it is completely covered in the chapter devoted to "Depreciation—Obsolescence—Appreciation."

The statement that corporations may not deduct donations is a little too inclusive. Article 562: "Donations made by a corporation for purposes connected with the operation of its business, when limited to charitable institutions, hospitals, or educational institutions, conducted for the benefit of its employees, or their dependents, are a proper deduction as ordinary and necessary expenses." Also, you will note by reading this Article that certain other donations are deductible, but note particularly, "sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than Trade Advertising, and contributions for campaign expenses are not deductible from gross income." The example of the stove dealer cited above may also illustrate the procedure that would be followed in arriving at the gross income of any dealer, and with accounting modifications which have no bearing on tax law, may be applied to manufacturers and other forms of business.

One thing to note particularly in the matter of inventories is that the inventory at the beginning of the year must coincide exactly with the inventory shown on the books at the close of the previous year. If this is not the case you will probably have to correspond with the taxpayer, and ask him to explain (in case he has not done so in his return) the discrepancy.

Interest

Under the 1917 Income Tax Laws the amount of interest that was deductible is limited. Under the Act of 1918 the amount deductible is not limited, but an exception is made of interest paid for one specific purpose.

Interest on indebtedness incurred or continued to purchase or carry an asset (usually a security) the interest (note the law says: "Interest," not "income") from which is wholly exempt from taxation, is not deductible.

This last item has caused a great deal of confusion in the minds of students and auditors. An inadmissible asset is an asset, the income from which (be it interest or dividends) is exempt from tax. In this class of assets may be named municipal bonds and industrial stocks, for in the case of municipal bonds the interest is exempt from taxation, and in the case of stocks, the dividends received therefrom are exempt from tax. Now, if a corporation borrows money to purchase a municipal or state bond, it cannot deduct the interest paid (or accrued) from gross income in arriving at taxable net income, because the interest returned by the bonds is exempt from taxation, but if it borrows money to purchase industrial stocks, the interest paid (or payable) on this money is deductible for the reason that the law refers only to the matter of non-taxable interest, and is silent on non-taxable dividends. Whether this was intentional on the part of Congress, or was an oversight, is immaterial to us. Right or wrong the canons of the law must be carried out. It is not incumbent upon us to decide what Congress intended to do; we must follow along with what it *did* do.

Some have formed the erroneous opinion that the deductibility of interest paid to purchase or carry stocks automatically restores the stock to admissible assets. Such is not the case. The subject of asset classification is ex-

tensively treated in the chapter devoted to "Admissibles and Inadmissibles."

The expressions "incurred or continued" and "to purchase or carry" have seemed ambiguous to some. Interest "incurred" is interest on money borrowed during the taxable period to "purchase" non-taxable bonds, while interest "continued" is interest on money borrowed during a previous period, and which is still being used to "carry" the bonds.

CHAPTER THREE*

INCOME FROM LEASED PROPERTIES AND CORPORATIONS IN LIQUIDATION (ARTICLES 546 AND 547)

Income—How Determined

Income ordinarily includes gains, profits and income derived from every source whatsoever and, broadly speaking, means all wealth flowing in to the taxpayer other than a mere return of capital. However, gains derived from the sale or other disposition of capital assets are income. Furthermore, there are other items which are income-determining factors besides cash, among which are inventories, accounts receivable, property exhaustion and accounts payable for expenses incurred. Gross income for income tax purposes embraces all of the above forms of income unless wholly exempt from tax by statute. When income is derived from leased property and corporations in liquidation, its taxability is determined in accordance with the following principles:

Lessor and Lessee

Buildings and land owned by corporations are frequently leased to other corporations by which the lessee corporation secures control of competing concerns through rental of a certain plant or property over a period of years. This may also occur where a corporation wishes further

*This chapter is from the pen of Mr. John M. Hartman, Assistant Chief, Training Section, Income Tax Unit.

to avoid the expense of building operations or the necessary delay in beginning business in connection with erecting buildings and plant. On the other hand the lessor corporation may desire to lease its plant in order to be relieved of the operation of its property, and at the same time receive a satisfactory return on its capital in the way of rentals. Leases actually run from 1 to 50 years and sometimes as high as 99 or 999 years. Leases of this nature, however, are equivalent, to permanent ownership and the lessee corporation may improve the property as desired. As a rule the lessee corporation obligates itself to pay tax, insurance, and the upkeep expense of the leased property. The corporation owning the property is designated as the "lessor;" the corporation securing the lease is called the "lessee."

Advantages

Moreover, it may be advantageous for a corporation to lease its property over a fixed period by which a certain return on its investment is guaranteed rather than conduct its business with the possible chance of loss where competition is very keen. Leased property continues in possession of the lessor and must be returned at the expiration of the lease. The advantages to the lessee may be cited as long occupancy, which enables the lessee to plan for future business and the establishment of pre-determined rental, advantages which might be necessary in the case of continuous interruptions where changes of location should occur. A permanent location is much desired in establishing goodwill and the building up of trade where locations are desirable, and a long-term lease meets this requirement at least in part, as it insures the lessee corporation against open competition.

Income from Leased Property

When a corporation leases its property to another

corporation under a lease contract the proportionate amount of annual rental for each year is taxable income to the lessor corporation during the life of the lease. Let us assume that:

Payment Direct to Corporation

Corporation A, the lessor corporation, leases its plant to the B Corporation for \$10,000 for a period of ten years, to be paid annually. The A Corporation reports income at the rate of \$1,000 per annum for ten years. However, in case of a short-term lease, where the entire amount of the lease for the period held is paid the first year of the lease, the entire amount received for the lease would be taxable income to the lessor for the year received, provided its books are kept on a cash receipts basis. Where a corporation has leased its property and the lessee in lieu of other rental agrees to pay an amount equivalent to a certain rate of dividend on the lessor's capital stock or the interest on the lessor's outstanding indebtedness, together with tax, insurance or other fixed charges, such payments shall be considered rental payments and shall be returned by the lessor corporation as income.

Payment to Stockholders and Bondholders

When payments on a lease are made directly to the stockholders and/or bondholders of the lessor, they are still considered as income to the lessor corporation. Simply because a corporation has parted with the management and control of its property or has ceased to engage in the business for which it was originally organized will not relieve it from tax liability. Payments of this nature made by the lessee corporation directly to the bondholders or stockholders of the lessor corporation are considered as rental as to both the lessee and lessor corporation. They are considered as rentals paid in one case and rentals received in the other. Any amounts received by the bond-

holders and stockholders in this case are considered as interest and dividend payments received from the lessor, and as such should be accounted for in their returns.

Illustration

As an illustration of the above, assume that Corporation A leases its plant and property to Corporation B, under which arrangement Corporation B is to pay to the stockholders and creditors of Corporation A a dividend on preferred stock of 2% and interest on accounts payable amounting to \$1,200, together with taxes or other fixed charges. These payments are considered as additional rental and should be returned by the A Corporation as income even though the dividends and interest are paid by the B Corporation directly to the bondholders and stockholders of the A Corporation. Since the expenses of rental, taxes, and interest (except interest on inadmissibles) are deductible items when incurred in a taxpayer's business or trade, it is evident that the above expenses when thus paid for another corporation constitute allowable deductions in every case and must be taken into consideration in computing its net income.

Improvement by Lessee

In many cases where the lessee enters into a contract for a lease of land an arrangement is entered into whereby the lessee erects thereon a building which reverts to the lessor upon the expiration of the lease. Usually the building erected under this arrangement is not subject to removal by the lessee.

In accordance with a Circuit Court decision of the Ninth District; *Miller vs Gearin*, 258 Federal 225, the following was cited: "Assuming that the building was income derived from the use of the property we think it clear that the time it was derived was the time when the com-

pleted building was added to the real estate and enhanced its value." It is therefore clear that if a building is erected on leased property by the lessee the cost of the building is income to the lessor when the title passes to the lessor and not at the termination of the lease.

Proportion of Cost to be Included as Income to Lessor

Since the court has decided that the cost of the building is income to the lessor when title passes, we must ascertain what amount of the cost shall be included as income by the lessor. In view of the fact that the lessee retains possession of the property during the life of the lease it is evident that the lessor does not obtain full value at the time the title passes.

It would seem only equitable, and a ruling has been so promulgated by the courts, that the lessor include as income only the depreciated cost value of the building as at the termination of the lease; that is, the lessor is allowed to deduct the amount of depreciation which would accrue during the life of the lease as soon as the title passes and thus include as income only the net value of the building as determined by the life of the building and the length of the lease. If the lease extends over the life of the building no income will be realized by the lessor when the title passes, since the depreciation on the building over the life of the lease would extinguish its entire cost before the lease expired. The following extracts are taken from the ruling laid down by the courts which clearly interprets this proposition:

A, in 1915, leased certain land to B for twenty years. B agrees, in part consideration for the lease, to erect on the leased ground, a building, specifications agreed upon, of an estimated life of twenty-five years and to cost \$50,000, which building is not to be subject to removal by B. The building is completed in 1920.

A realizes income in 1920, the year in which title to the building passes. The measure of the income is the present value to A of the building, of an estimated life of twenty-five years and cost of \$50,000, the use and enjoyment of which is postponed for fifteen years. Depreciated value of the building at the termination of the period of the lease will be approximately \$20,000—that is, cost less depreciation sustained. The income of A, then, is the discount value of \$20,000 receivable at the end of fifteen years.

If market value reflects intrinsic value this amount should equal the difference between the value of the land free from the lease without the building and the value of the land subject to the lease with the building. However, any other evidence available should be considered in determining this present worth to the taxpayer of the legal title to the encumbered building.

Since A has included in income only the depreciated value of the building, he is entitled to depreciation deduction with respect to such building only for the years after the termination of the period of the lease when A has come into possession. This depreciation deduction to which A is entitled for 1935 and subsequent years should be computed on a basis of the estimated remaining life of the building and a cost value equal to the market value placed on the encumbered building by A in the year of its erection, that is, the annual depreciation for 1935 and subsequent years will be the quotient obtained by dividing (a) the value of the improvements to A as determined by him when the same building became part of the realty by (b) the number of years in the estimated remaining life of the improvements from the termination of the lease.

The following illustration will depict the working of the above explanation:

Supposing in 1920 Corporation A leases a parcel of

land from Corporation B for \$10,000 for ten years to be paid at the rate of \$1,000 per annum. A agrees to erect immediately upon this land a building costing \$20,000, the life of which is estimated at twenty-five years. What effect has the erection of the building upon the gross income of Corporation B?

Illustration

Building erected in 1920 cost.....	\$20,000
Life of building, 25 years, which determines depreciation rate of 4% per annum; 4% of \$20,000=\$800 annual depreciation.	
Total depreciation for ten years, or during period of lease.....	8,000
Total income to lessor when title passes:.....	\$20,000
Less: Total depreciation during life of lease..	8,000
	<hr/>
Depreciated cost of building to Corporation B in 1920.....	\$12,000
	<hr/>

How to Determine Amount to be Included as Income in 1920

In accordance with T. D. 3062, as interpreted in Cumulative Bulletin No. 4, Ruling 8-21-1474 it is necessary to compute the discounted value of the \$12,000 receivable at the end of ten years, or in other words, to determine the amount that must be included in income for 1920 that will equal \$12,000 at the end of ten years, the conclusion of the lease. The present value of a sum due at a fixed future date is a smaller amount which, with interest, will accumulate to the future sum. That is, the present value of \$12,000 due in ten years, say at 6%, is a sum smaller than \$12,000, which with interest at 6% compounded for ten years will accumulate to \$12,000.

In order to demonstrate the principle, and as an illustration applicable to all cases, the following proposition

is worked out on the basis of one dollar at a rate of 6%. The question involved is to determine what amount at the present time will equal one dollar at the end of ten years at 6% compound interest.

It is necessary first to ascertain what will be the amount of one dollar at the end of ten years at this rate; that is, we must compute the amount of one dollar at compound interest at 6% which is found to be \$1.79084770. This amount divided into \$1 equals \$0.55839478, the discounted value of one dollar, or, in other words, the amount which is required at the present time to equal one dollar in ten years at 6% compound interest.

After the discounted value or present worth of one dollar is obtained, it is a very simple matter to find the discounted value of any other amount by multiplying this amount by the amount upon which the present worth is desired. Take in the case above where the depreciated cost of the building is found to be \$12,000 and it is necessary to compute the discounted value, or rather to find the amount that at the present time will equal \$12,000 in ten years. The first step is to determine the amount of one dollar at compound interest, at the prevailing rate (say 6%), at the end of ten years, which in this case is found to be \$1.79084770. This amount divided into one dollar equals \$0.55839478, the discounted value or present worth of one dollar as at the beginning of the first year, which multiplied by \$12,000 equals \$6,700.74, the discounted value of \$12,000 at the beginning of the first year, receivable at the end of ten years.

During the first year the accrued income earned on account of the discount allowed amounts to \$402.04. Therefore, the correct income taxable at the end of the first year is the sum of \$6,700.74 plus \$402.04, or \$7,102.78. Corporation B is therefore required to report as income

for 1920 \$7,102.78 on account of the erection of the building by Corporation A.

Another simple method of determining the discounted value of the above \$12,000 is to divide the amount of one dollar at compound interest, \$1.79084770, computed as above, into the \$12,000, which equals \$6,700.74, the discounted value of \$12,000.

On the other hand, say for example, that the lessee has in the above instance acquired the lease in 1916 and the building was erected in 1921. How will this affect the income of the lessor corporation?

Lease acquired in 1916 at a cost of \$10,000....	\$10,000
Building erected in 1921 at a cost of \$20,000..	20,000
Annual depreciation on building at 4%, \$800.	
Remaining life of lease after erection of building 5 years.	
Total depreciation during life of lease.....	4,000
Total income to lessor when title passes upon erection of building.....	\$20,000
Less: Total depreciation over remaining life of lease	4,000
Depreciated cost of building to Corporation B in 1920.....	<u>\$16,000</u>

In this case the amount of one dollar at compound interest at 6% for five years is \$1.33822558. This amount divided into \$16,000 equals \$11,956.13 which at the beginning of the year, is the discounted value or present worth of \$16,000 receivable at the end of five years. During the first year the amortized discount is \$717.37, which must be added to the above amount, making \$12,673.50, total income for the year. Or according to another method the discounted value or present worth of one dollar at compound interest at 6%, which is \$0.74725817, multiplied by \$16,000

equals at the beginning of the year, \$11,956.13, the discounted value of \$16,000 receivable at the end of the period. This amount plus the amortized discount of \$717.37, makes the total income for the year \$12,673.50. In this case the lessor corporation should report as income for 1921 the sum of \$12,673.50 on account of the erection of the building by the lessee corporation.

Effect of Present Worth on Subsequent Years

The income for subsequent years in such instances is affected by the amount of the increased discounted value for each succeeding year of the depreciated cost of the building as at the termination of the lease. The present worth or discounted value as at the beginning of the first year of \$12,000 for a period of ten years, is \$6,700.74. During the first year the accrued income earned on account of the discount allowed amounts to \$402.04. Therefore the correct income taxable at the end of the first year is the sum of \$6,700.74 plus \$402.04, or \$7,102.78.

Since the depreciated cost of the building at the expiration of the lease is \$12,000, but only \$7,102.78, the discounted value of the building as at the end of the first year, is reported as income for the first year, the difference between this amount and the depreciated cost of the building as at the expiration of the lease must be amortized over the remaining life of the lease on the basis of the present worth of the depreciated cost of the building for each year and included as income. The amount of the discount allowed in computing the present worth of the building for each year accrues as income to the lessor on the basis of the rate per cent of discount used. In view of the fact that the discounted value of the building is taken in advance, for the period covering the life of the lease, the amount of this discount for each year is an increment

to the asset value of the lessor and must be considered as income.

An illustration of this proposition based on 6% compound interest for a period of ten years, is computed in the following manner:

Amount Receivable at End of lease	Number of Years Discount Compounded	Present Worth Beginning of Each Year	Income Realized	End of Taxable Year
\$12,000	10	\$6,700.74		
12,000	9	7,102.78	\$7,102.78	1920
12,000	8	7,528.95	426.17	1921
12,000	7	7,980.69	451.74	1922
12,000	6	8,459.53	478.84	1923
12,000	5	8,967.10	507.57	1924
12,000	4	9,505.12	538.02	1925
12,000	3	10,075.43	570.31	1926
12,000	2	10,679.95	604.52	1927
12,000	1	11,320.75	640.80	1928
12,000	0		679.25	1929
Total income realized.....		\$12,000.00		

Effect of Lease Extending Beyond Life of Building

If the term of the lease extends through or beyond the life of the building there is no income to the lessor when the title passes, since there would be no value remaining to the lessor after the expiration of the lease. That is, the lessee would get full value of the building or improvements during his possession of the property. The income of the lessee is affected by leaseholds in that it is an allowable deduction in computing net income. As an example, we will say the lessee pays \$10,000 for a lease for ten years paying \$1,000 per annum. This \$1,000 is an allowable deduction as rental each year at arriving at net income.

Furthermore, if the lessee erects a building costing \$10,000 on property leased for ten years, in order to return to the lessee his investment of capital, an annual deduction may be made from gross income of \$1,000 which is an amount equal to the total cost of such improvement divided by the number of years remaining in the lease, which deduction should be in lieu of a deduction for depreciation.

Income of Corporations in Liquidation

A corporation may liquidate for various reasons. The charter may expire or the State may cancel the charter in accordance with certain rights which it reserves at the time of issue. A corporation may surrender its charter. However, the most common reason for liquidating is insolvency. This usually means that the assets of a corporation are less than the debts. This emphasizes the economic viewpoint that a corporation is legally insolvent when the cash assets are not sufficient to pay the debts when they become due. There are several methods of liquidation which are usually classed as follows:

- Bankruptcy
- Voluntary Dissolution
- Receivership

Usual Method Through Receivership (or Trustee)

If a corporation has been operating at a loss and finds that it is necessary to dissolve, the usual procedure is to turn the affairs over to a receiver who winds up the business and liquidates the capital. When a corporation is obliged to go into liquidation the corporate existence is continued until a trustee completes the liquidation of the assets and pays the debts. The trustee in this way stands in place of the corporation to conduct its business and is required to render a return of income for the corporation. As prop-

erty is sold by the receiver (or trustee) any gain or loss is treated by the receiver (or trustee) in the same manner as if handled by the corporation itself.

The trustee, in winding up the affairs of an insolvent corporation, charges himself with all money realized by the sale of the assets and credits himself with payments for liquidating the liabilities and other expenses, including his commission. A distinction should be made between gain or loss in the sale of assets or property and a liquidating dividend which represents a return of any portion of the capital to its stockholders. In other words, a liquidating dividend is a payment to the stockholders of any amount of capital invested in the business. However, any excess so received over the cost of his stock to the stockholder, or over its fair market value as of March 1, 1913, if acquired prior thereto, is taxable profit.

Should a gain be made in the sale of property, as in the case of manufactured articles, this should be included as income to the corporation.

CHAPTER FOUR*

DEDUCTIONS ALLOWED—BUSINESS EXPENSES

(SECTION 234)

Deductions

Statutory deductions are, in general, though not exclusively, expenditures other than capital expenditures, connected with the production of income. This practically established the fact that ordinarily all revenue expenditures are deductible items in determining net income. Revenue expenditures are what has been expended to earn income. That is, revenue expenditures may be said to be the generic term including cost, expenses and losses in opposition to income, earnings or profit. However, there are a few exceptions as to all statutory deductions being revenue expenditures in computing net income for tax purposes, and the commercial usage of revenue expenditures used in determining net income. Take for instance a corporation, in commercial accounting, customarily considers charitable contributions, advertising (other than of trade advertising) and contributions for campaign expenses as ordinary revenue expenditures. While, technically speaking, this is correct in commercial usage, these items are not deductible from gross income in computing net taxable income. Taxable net income is wholly a statutory conception but with a few modifications in making deductions and the statutory exemptions, it follows the usual lines of commercial net

*This chapter is from the pen of Mr. John M. Hartman, Assistant Chief, Training Section, Income Tax Unit.

income. This is to be assumed and only reasonable, since it is ordinarily computed upon the same basis and in accordance with the same methods of accounting as generally employed in all commercial corporation accounting.

When Allowable

All ordinary and necessary expenses known as "business expenses" in order to be deductible, must be for the year in which paid or incurred. In the case of a corporation making a return on an accrual basis, it may deduct all authorized allowances whether paid in cash or set up as a liability. This is equivalent to the fact that if the corporation does not pay or accrue within any year certain of its expenses, nor take them as a deduction, it cannot for the next or any subsequent year make a deduction from income of any such amounts which are later paid in the liquidation of such prior year's liabilities or expenses.

Period Covered

The law requires that a corporation make its return for each year complete in itself, so far as practicable, both as to gross income and the proper deductions taken.

Failure to Charge off the Books

Let us assume, for example, that a corporation in 1918 has an expense item of \$200 for incidental repairs, which through a bookkeeping error was not charged off on the books, and consequently not taken as a deduction. In 1919 they discover the error and charge off this amount on their books and deduct it in their 1919 return. Would this be allowable? No. Since this is not an allowable deduction in computing income for the current year this amount must be added back to the book income in computing current net income for 1919. However, in case a taxpayer discovers subsequent to its occurrence the amount of the loss sustained during the prior taxable year, which has

not been deducted from the gross income of the prior year, he may render an amended return for such preceding taxable year and include the amount of such loss in the deductions from gross income for the year in question. In this event a claim for refund must be filed for the excess of tax paid on account of the excessive income reported upon which tax was paid for the year that such loss should have been deducted.

Embezzlement and Suit for Judgment

Take another case where a corporation lost \$5,000 on account of embezzlement in 1918, but does not discover this fact until 1921. It cannot deduct this amount from gross income in computing its 1921 net income. In order to secure relief in this instance it would be necessary to file an amended return and claim this amount as a deduction in its 1918 return. However, any amount paid pursuant to judgment or otherwise on account of a patent infringement or otherwise, is deductible from gross income when the claim is put in judgment or paid, and not when the suit is instituted.

Let us assume that a case was taken to court for relief on account of infringement of patent for \$10,000 in 1918 and remained in the courts until 1920, when judgment was rendered for \$5,000, but not paid until 1921. In computing net income the question arises as to what amount would be deductible and when. In this case the proper amount deductible in computing net income would be \$5,000 for the year 1920 when the judgment is rendered.

Any expense in connection with a suit of this kind, however, would be deductible for the year in which incurred. That is, expenses of prosecution, such as attorney fees, witness fees, or other expenses, are deductible in the year when incurred or paid, even though no judgment is rendered during the year of such expense, but in a sub-

sequent year. Remember, that the amount of any judgment is deductible only for the year in which the judgment is rendered.

There are a few somewhat unusual expenses which are considered as "business expenses," among which are the following: Penalty for filing delinquent tax returns, entertainment expenses and subscriptions to business magazines.

Business Expenses

Under the Revenue Act of 1918, there are a great number and variety of items included under "business expenses." Business expenses may be taken as deductions either by subtracting from the total receipts in computing gross income or deducting directly from gross income in determining net income. Business expenses include all items entering into what is ordinarily known as the "cost of goods sold" along with selling and management expense, but does not include the following items which are treated separately: Taxes, losses, bad debts, depreciation, amortization, depletion, charitable contributions and loss in inventory. The items that are to be considered as business expenses may be classed as follows: Material, labor, supplies, repairs (in case of manufacturing), goods bought for resale, reasonable compensation for services of officers, advertising and other selling expenses, insurance premiums against fire, storms, theft, accident, or other similar losses, and rental for use of business property. As a matter of fact, any deductions, except as noted above, may be taken by a taxpayer if the expense is incurred in carrying on his trade or business.

Cost of Material

In computing the cost of material, the charges usually include only the amount that was consumed in operation

during the year for which the return is made. The cost of material is properly ascertained by the inventory method which includes the consumption of goods as reflected by the inventories taken at the beginning and end of the year, as the following illustration indicates:

Inventories at beginning of year.....		\$35,000
(To be reconciled with balance sheet)		
Purchases during the year.....		22,000
		<hr/>
		\$57,000
Labor and wages ordinarily charged to man- ufacturing	\$20,000	
Other expenses ordinarily charged to man- ufacturing	3,000	23,000
		<hr/>
Total		\$80,000
Inventory at end of year.....		30,000
		<hr/>
Cost of goods sold.....		<u>\$50,000</u>

Repairs

The principal reason for repairing plant or machinery is to keep them in working condition. Repairs in the nature of replacements to the extent that they arrest depreciation and appreciably prolong the life of the property should be charged against a depreciation reserve. Any expense which in any way increases the utility of the machinery should be charged to a capital account. It is sometimes difficult to distinguish between ordinary repairs which are necessary to keep machinery in good running condition, and other expenditures (sometimes called repairs) which are in reality improvements, or capital expenditures, to the extent that they arrest depreciation and which should be charged against a depreciation reserve.

Illustration

Let us assume that an expenditure is made for a new cylinder, a gasket, or for grinding the valves of an automobile, costing from \$3 to \$5, which adds simply to the upkeep of the machine and maintains it in a proper running condition. This is purely an expense for repairs. On the other hand, let us assume that an expenditure is made for automobile bumpers, chains or some other special attachment costing from \$20 to \$50, which adds to the value of the machine. This is considered a capital expenditure. When an expense for repairs, so called, has increased the efficiency of the plant or machine, such an expense should be appropriately capitalized, but if the expenditure has not increased the output of the machinery but has only kept it at its previously stated efficiency, the value of the machine has in no sense been increased, and the expenditure would be chargeable to revenue or repairs.

Professional Expenses

A great many corporations are members of trade societies and organizations interested in the principal trade or business in which the corporation is engaged, such as manufacturers' associations, furniture dealers' associations and numerous other combines of the same character. Corporations that are members of such societies are required to pay certain membership fees and annual dues. Expenses of this nature are business expenses and allowable deductions.

Illustration

Say a corporation pays \$25 per annum dues to an engineering society and also purchases a set of engineering books for use in its office. The amount paid for dues for membership in the society is a deductible item, while the cost of the books is a capital expenditure.

Any expense which may be necessary in carrying on the business along professional lines or of the trade or business, such as subscriptions to magazines which are used in the business, are deductible. However, no amounts expended in a professional way for equipment, books, furniture, etc., of a permanent character, are allowable deductions.

Compensation for Personal Services

Illustration where Payments for Compensation are Reasonable and for Personal Services Actually Rendered.

When Salaries and Other Compensation Deductible

Salaries or other compensation for personal services incurred in carrying on any trade or business may be included at a reasonable allowance. A test further in case of compensation as to its deductibility is whether it is reasonable and if the payments are purely for services rendered. The form or method of fixing compensation is not decisive as to deductibility.

While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Services of an individual for payment not pursuant to a free bargain made before the services are rendered and not influenced by any consideration on the part of the employee other than that of securing the service on fair and advantageous terms shall be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which was ordinarily to be paid.

In any event, the allowance for compensation paid may not exceed what is reasonable in all circumstances. It is,

in general, just to assume that reasonable and true compensation is only such an amount as would ordinarily be paid for like services by like enterprises in like circumstances, such circumstances to be taken into consideration, or those existing at the date when the contract for the services was made and not those existing at the date when the contract is questioned. Where no determination of compensation is had until the completion of the service, the amount received is income for the taxable year of its determination if the return is rendered on the accrual basis.

In determining a reasonable compensation for officers of a corporation, the averages as compiled in Bureau of Internal Revenue Bulletin "Average Percentages of Net Income to Gross Income," may be used, which gives a comparison with similar average percentages of net income to gross income returned by concerns engaged in like businesses. The formula given in this bulletin follows:

Gross income returned by the taxpayer, times average percentage of net income to gross income equals net income that should have been returned by the taxpayer.

Net income returned by the taxpayer plus compensation deducted minus net income that should have been returned by the taxpayer, equals compensation allowable.

There is, however, no hard and fast rule that can be applied for the determination of the amount that should be considered reasonable compensation in every instance. Moreover, the comparatives as shown in this Bulletin are not to be followed in all cases but may be disregarded if the circumstances in any case are so extraordinary as to make it clear that the corporation in question cannot properly be considered as comparable with other corporations of the same class to which it naturally belongs.

Illustration where Payments for Compensation for Personal Services are not Purely for Services Rendered.

(a) Sometimes amounts are paid in the form of compensation but are not in reality the purchase price of services. Such items are not deductible.

Illustration

A corporation is paying an officer of its company a salary of \$5,000 per annum on a calendar year basis for services as secretary of the corporation. This officer finds that in October he has some personal affairs to attend to and takes furlough for the balance of the calendar year. The corporation, in consideration of his faithfulness in the past, decided that it will pay his full salary, and deduct the total amount of such salary in computing net income. Would this be allowed as a deduction? No, since it does not represent the purchase price for services rendered. The correct amount deductible would be \$3,750.

Furthermore, salaries can be deducted only for the year in which the service is rendered. That is, a deduction claimed for salaries in 1920 for services rendered in 1918 is not allowable.

(b) An ostensible salary paid by a corporation may be a distribution of a dividend on stock.

Supposing a corporation having only a few stockholders practically all of whom draw salaries, pays excessive amounts as salaries, it would appear that the salaries, if in excess of those ordinarily paid for the same service, are not paid wholly for the service rendered, but in part as a distribution of earnings.

Illustration

This could occur in case of a close corporation, which we will say is composed of three stockholders who are also the officers of the corporation; president, treasurer and

secretary, each holding \$15,000 worth of stock. The corporation reported a net income for the taxable year of \$12,000, but it is discovered in auditing its return that it has deducted for salaries \$18,000. This deduction is, of course, out of all proportion to the correct amount deductible for a corporation of this amount of capitalization and would indicate that part of the earnings are being distributed upon the stock held and a salary deduction should therefore be allowed commensurate with the amount of business and capitalization as compared to other corporations, in accordance with the comparative salary table referred to previously.

(c) An ostensible salary paid by a corporation may be in part a waste or appropriation of assets of the corporation. Where salaried employees are in control of the corporation and are either holding directly or indirectly a majority of its stock or in case of a large corporation with many stockholders owning a substantial minority of its stock, the tendency is to inflate salaries.

Illustration

Let us suppose that a corporation is operating at a very small profit, and it decides that its officers should receive a large salary, regardless of its earnings. It managed to dispose of some of its assets and this was returned as paid out in salaries, which as a matter of fact is nothing more than a liquidation of capital paid to its officers as salary. A close analysis of the balance sheets would reveal the condition carried on in this manner and the proper salary adjustments should be made.

(d) An ostensible salary may be part payment for property. Let us assume a case where officers continue in the service of a corporation where a partnership sells out to a corporation. It might be found in such an instance

that the salaries constitute payment for the transfer of their business.

Treatment of Excessive Compensation

When amounts are ostensibly paid as compensation but not allowed, their treatment can usually be determined in the following manner:

If the payments correspond or bear a close relationship to stockholders, the amount of the excess should be treated as a dividend.

If such payments represent an appropriation of assets of the corporation by the officers who control it, and fix their compensation in violation of the rights of the corporation, the amount of excess, while disallowed as a deduction by the corporation, should be treated as compensation of the individuals subject to the normal tax.

If excessive compensation is paid and such payments constitute in part payment for property, the amount of the excess should be treated by the corporation as a capital expenditure.

Compensation Paid Other Than Cash

Sometimes it may be desirable for a corporation to pay for services rendered with something other than cash. This is permissible, but in determining what amount should be allowed for services rendered when paid for in this way, the fair market value of the thing taken in payment must be considered as the amount of compensation paid. Furthermore, it is presumed that the compensation received is the fair value for such services if the services were rendered at a stipulated price. A corporation may desire to pay compensation to an employee in stock in which case the amount of compensation is determined by the market value of the stock as if sold by the corporation and the

employee paid in cash. Where living quarters, such as a camp, is furnished an employee for the convenience of the employer, the ratable value should not be considered as cash compensation to the employee, but if the employee is furnished living quarters in addition to salary for services rendered, the value of such living quarters furnished constitutes an allowable deduction in the way of additional compensation.

If a corporation should pay an employee in land for services rendered in 1919, the title to which might be in dispute and in 1920 the title adjudged to be valid, constitutes a deduction for compensation only in 1919.

Bonuses to Employees

Bonuses paid in good faith and as an additional compensation for services actually rendered by employees, provided such payments when added to the stipulated salaries do not exceed reasonable compensation for services rendered, constitute allowable deductions from gross income.

Illustration

Let us suppose that a corporation pays its secretary \$2,000 per annum, but owing to a great deal of extra work done in evenings and on some holidays, they decide at the end of the year to pay him an additional sum of \$500 for this special service. This additional compensation paid would be an allowable deduction. Again, let us suppose that an employee works by piece work and is paid at the rate of \$6 for finishing and riveting 600 grain drill plates per day, and a quarter of a cent bonus on all over 600. At the end of the year the additional compensation so paid to all employees amounts to \$2,000. This would properly be an allowable deduction from gross income.

However, let us suppose in case of the secretary of the

corporation, who is paid \$2,000 per year, that the corporation desires to reward him in some manner and decides to present him with a purse of \$200 as a gift. Such an expense or bonus cannot be taken as a deduction in computing net income, since it is in the nature of a donation, as no commensurate service has been rendered. It does not have the element of compensation and should be considered as in excess of reasonable compensation for services rendered. Such payments as these are in the nature of gratuities and not deductible from gross income.

Pensions

Pensions, when paid to retired employees or their families, or others dependent on them, on account of injuries received, and lump sum amounts paid as compensation for injuries are considered as proper deductions as ordinary expenses. Such amounts are limited to the amount not compensated for by insurance or otherwise. In case a corporation sets aside or contributes a certain amount each year to a fund called a "pension fund" which is held by the corporation, the amount so contributed is not deductible in this case, but the amount actually paid to the employee is deductible.

Illustration

Supposing a corporation contributes each year \$500 to a fund for pensions and during the year it paid to disabled or retired employees \$300 of this amount. The amount actually paid out to the employees, \$300, is deductible from gross income while the amount contributed to the fund is not deductible.

Rentals

A corporation acquires a leasehold on certain property for \$10,000 for a period of ten years for which it pays

at the rate of \$1,000 per annum. This amount for each year, over the term of the lease, is an allowable deduction. On the other hand, say the amount of the lease is paid for the full amount of \$10,000 at the time of acquiring the lease. The amount deductible is still only the aliquot part of such sum each year based on the number of years the lease is to run. If any taxes are paid by the tenant to or for the lessor, this constitutes additional rent and is a deductible item to the lessee. Where the lessee erects a building or makes permanent improvements on leased ground, the costs of such buildings or improvements are held to be capital investments and not deductible as business expenses. However, in order to return to the lessee his investment of capital, an annual deduction may be made from gross income of an amount equal to the total cost of such buildings or improvements divided by the number of years remaining of the term of the lease and such deductions shall be in lieu of a deduction for depreciation. If the remainder of the term of the lease is greater than the probable life of the buildings or improvements, the deduction should take the form of an allowance for depreciation.

Illustration

Let us assume that the lessee erects a building that cost \$20,000 on a piece of land leased for ten years. In order to obtain relief and a return of his capital he deducts for each year the amount of \$2,000 during the life of the lease, which deduction shall be in lieu of depreciation. However, in case where a lease runs for 30 years and the buildings erected thereon have a life of only 25 years, then the deduction shall be taken as depreciation over the life of the buildings. Thus in the above case depreciation would be deductible at the rate of 4% per annum based on the cost of the buildings.

All rentals for business property are deductible unless such rental is for property on which the taxpayer has taken or is taking title, or in which he has an equity. However, rental for personal property is not deductible.

CHAPTER FIVE

CORPORATION BONDS—GAIN OR LOSS

I. Corporation Bonds

Illustrating Article 544

(1-a) If bonds are issued at face value, that is, if a corporation receives an amount for the bond that would be just sufficient to redeem it (say it receives \$100 for a bond, the face value of which is \$100), no gain is realized; neither is any loss suffered.

To illustrate each of the other subdivisions of this article, we will assume that the Simpson Company issued four different series of bonds, each series amounting to \$10,000, and that the various shares brought variant prices, and (or) that the bonds were redeemed at prices different from the value received at the time of the sale. Also the life of all bonds is assumed to be ten years and the interest rate is 5%.

(1-b) Series "A" bonds were issued at face value January 2, 1913. At January 2, 1918, the bonds are purchased and retired, the purchasing price being 104.

Bonds cost the company.....	\$10,400
Company received for the issue.....	10,000
	<hr/>
Amount deductible in 1918.....	\$ 400
	<hr/> <hr/>

(1-c) Series "B" bonds were issued at face value

January 2, 1913. At January 2, 1918, the bonds are purchased at 98 and retired.

Company received for the issue.....	\$10,000
Bonds cost the company.....	9,800
	<hr/>
Taxable income for 1918.....	\$ 200
	<hr/>

(2-a) Series "C" bonds were sold January 2, 1918, at 105.

Total amount received by the company.....	\$10,500
Face value of the bonds.....	10,000
	<hr/>
Taxable income to be amortized.....	\$ 500
	<hr/>

Of the \$500 taxable income, \$50 must be reported in each of the ten years representing the life of the bonds.

(2-b) Series "C" bonds were purchased January 2, 1920, at 106 and retired.

Cost to retire the bonds.....	\$10,600
Issuing price.....	\$10,500
Less amount returned as income (2 years) .	100 10,400
	<hr/>
Expense deductible for 1920.....	\$ 200
	<hr/>

Or (2-c) Series "C" bonds were purchased January 2, 1920, at 100 and retired.

Issuing price.....	\$10,500
Less amount returned as income (2 years).....	100
	<hr/>
	\$10,400
Cost to retire bonds.....	10,000
	<hr/>
Taxable income for 1920.....	\$ 400
	<hr/>

(3-a) Series "D" bonds were issued at a discount of 10% January 2, 1918.

Face value of bonds.....	\$10,000
Issuing price.....	9,000
	<hr/>
Amount of discount to be amortized.....	<u>\$ 1,000</u>

Each year during the life of the bonds, \$100 may be deducted from gross income as representing what is in effect additional interest. It is evident that the purchaser receives actually not 5% on his investment, but a rate considerably higher, for on each \$90 he invested in a bond, he receives \$5 in interest, or a rate of .05555, plus a portion of the \$1,000 he will receive at maturity of the bonds in addition to what he paid for them.

(3-b) At January 2, 1920, the company purchased the above bonds at face value and retired them.

Issuing price.....	\$9,000
Amount amortized over two-year period.....	200
	<hr/>
	\$ 9,200
Cost to retire the issue.....	10,000
	<hr/>
Amount deductible in taxable (1920) year.....	<u>\$ 800</u>

Or, (3-c) January 2, 1920, the company purchased and retired the above bonds paying therefor \$8,500.

Issuing price.....	\$9,000
Amount amortized.....	200
	<hr/>
	\$9,200
Cost to retire the issue.....	8,500
	<hr/>
Taxable income for 1920.....	<u>\$ 700</u>

A study of the foregoing illustrations will disclose the fact that the whole matter of computing gain or loss on transactions involving bond issues and retirements may be reduced to two general rules:

1. The difference between the face value and the sale price is to be divided by the number of years that the bonds are to run and this quotient is taxable each year during the life of the bonds provided the bonds sold above face value; or, if sold below face value, the amount represented by the quotient is deductible from gross income each taxable year during the life of the bonds.
2. (a) Bonds sold at par value if retired at a price different from that value, the difference is gain or loss, according as they were retired for more or less than the face value.
(b) When bonds, for which premium or discount has been amortized, are redeemed at a price differing from the issuing price, the difference is loss or gain, depending upon whether more or less was paid for them than was originally received. In the event of loss, we deduct from the loss the amount already amortized (since this loss was allowed in the amortization charges). In the case of gain, we deduct from the gain the amount already returned as income through amortization.

It should be noted particularly that in the cases where bonds are sold at a premium or at a discount, the total premium or discount, as the case may be, must be spread over the entire period of years representing the life of the bonds—in other words, the premium or discount must be amortized, crediting or charging Profit and Loss each year with its prorated amount of income or expense (deduction). In cases where the bonds are retired, the entire

gain, if any, is income for the taxable year, and the entire loss, if any, is a deductible item for the taxable year. Of course, if only a part of an issue were retired, the gain or loss would be computed only upon the amount retired, and the amortization of gain or loss on the unretired amount of bonds would be continued just the same as before.

II. Gain or Loss

1. The basis for determining gain or loss from the sale or exchange of property is cost. If the property was acquired on or after March 1, 1913, the basis is its cost or its approved inventory value as determined in accordance with Section 203.

2. (a) Where the fair market value of property as at March 1, 1913, is in excess of its cost, the gain to be included as income is the excess of the sale price over the fair market value as at March 1, 1913.

(b) If the fair market value as at March 1, 1913, is less than cost, the loss which is deductible is the excess of such fair market value over the sale price.

3. (a) No gain is recognized in the case of property sold or exchanged for more than cost but for less than its fair market value as at March 1, 1913, and no loss is recognized in the case of property sold or exchanged for less than cost but for more than its fair market value as at March 1, 1913.

(b) No loss is recognized where property is sold for more than cost but at less than its fair market value as at March 1, 1913.

(c) No gain is recognized where property is sold or exchanged for less than cost but for more than its fair market value as at March 1, 1913.

Illustrations

A purchased 100 shares of stock from the Y Manufacturing Company in 1912 for \$15 a share. The fair market value of this stock was \$20 a share on March 1, 1913. In 1920 he sold the 100 shares for \$25 a share. What was his profit from this sale?

Answer: A's profit from the sale was \$500.

B speculated and purchased 10 acres of land in 1911 for \$100 an acre. In the early part of 1913 it appeared that a tannery would be established on land adjacent to his property, and land which was adjacent to his property, and also adjacent to the land on which it was proposed to build the tannery was sold for \$175 an acre. In 1920 B sold his land for \$150 an acre. How does the sale of B's land affect his income tax liability for 1920?

Answer: It does not affect his income tax liability for 1920, because no loss or gain is recognized in this transaction.

C purchased 100 shares of stock from the M Railroad Company on January 5, 1913, for \$30 a share. This stock sold on the New York Stock Exchange for \$20 a share on March 1, 1913. In 1920 C sold his stock for \$18 a share. What entry should be made in C's return for 1920?

Answer: Loss of \$200.

D purchased an apartment house in 1909 for \$100,000. An appraisal of the property was made in February, 1913, and it was determined that its value at that date was \$75,000. In 1920 he sold the apartment house for \$80,000. How does the sale affect D's income tax liability for 1920?

Answer: It does not affect his income tax liability for 1920 because no loss or gain is recognized in this transaction.

CHAPTER SIX

PERSONAL SERVICE CORPORATIONS

What is a Personal Service Corporation?

By "personal service corporation" is meant one in which the income is attributable to the activities of the share or stockholders; that is, they not only render personal service but they actually perform to a large extent, that service. Such service is not necessarily of a professional nature, but is one in which capital (whether borrowed or invested) is not materially an income producing factor.

Personal service corporations are not subject to tax as corporations, unless they make returns on a fiscal year basis beginning in 1917, on Forms 1031 and 1103. An individual stockholder of a personal service corporation is subject to tax under the 1918 law (in much the same manner as a member of a partnership) upon his share of the earnings of the corporation, whether or not the earnings have been distributed.

Every personal service corporation must make a return of income regardless of the amount of its net income. The return shall be on Form 1065 (revised) for 1918 and subsequent years.

The net income of a personal service corporation is computed on the same basis as the net income of an individual except that no deduction is allowed for contributions. Thus, if a personal service corporation's books show a net increase of \$8,000 and a donation of \$1,000 was made to

the Red Cross, a stockholder holding one-fourth of the shares would have to report in his return an income (whether realized or constructive) from this source of \$2,250.

It should be noted, however, that in the event of a personal service corporation filing a return for a fiscal year beginning in 1917 that the individual stockholder will pay the tax at individual rates on his distributive share of the earnings attributable to the 1918 portion of the taxable period, while the corporation, as such, will pay income and excess profits taxes on that portion of the net taxable income attributable to the portion of the taxable year covered by the period beginning the first day of the fiscal period up to and including December 31, 1917, as is illustrated in the following problem in which it is assumed that the concern qualified as a personal service corporation.

Illustration

The Smith Engineering Corporation, a personal service corporation, was organized in 1912, doing business on a fiscal year basis ending June 30. Their invested capital for the taxable period was nominal. The owners consisted of A, B, and C who held stock $\frac{3}{5}$, $\frac{3}{10}$ and $\frac{1}{10}$ respectively. The net income reported was \$30,000.

Solution

1917 Law

Net income for fiscal year ended June 30, 1918.....	\$30,000.00
Less: Exemption	3,000.00
	<hr/>
Amount of taxable income.....	\$27,000
	<hr/>
Excess profits tax (8% of \$27,000).....	\$2,160
	<hr/>

Total net income.....	\$30,000
Less: Excess profits tax.....	2,160
	<hr/>
Income tax; 2% and 4% = 6% of.....	\$27,840 = \$1,670.40
Plus excess profits tax.....	2,160.00
	<hr/>
Total tax on basis of one year.....	<u>\$3,830.40</u>
	<hr/>
Tax for 6 months period ended December 30, 1917 (one-half)	\$1,915.20

Thus, it will be seen that the corporation as such should pay a tax of \$1,915.20 for the 1917 portion of the period and for the 1918 portion the tax will be paid by the stockholders, based upon their distributive shares, as follows:

1918 Law

As before stated, the individual owners of a personal service corporation are subject to tax much like the members of a partnership upon their distributive shares of the net income of the corporation.

A should pay a tax as an individual for the 1918 portion, being one-half of the fiscal year, on his share of the net income, or \$9,000 plus any other taxable income he may have received.

B, in the same manner as A, should pay a tax on his share amounting to \$4,500, plus any other taxable income.

C should pay a tax on his share, \$1,500, plus any other taxable income.

Any amount paid on account of the tax imposed under the Revenue Acts of 1916 or 1917 shall be credited towards the payment of the tax of the corporation under the portion applicable under the 1917 law, and if the amount so paid exceeds the amount of tax assessable, it shall be refunded in accordance with provisions of Section 252, Revenue Act of 1918.

The Difference Illustrated

Distinction between personal service and non-personal service will be illustrated in the case of two incorporated business schools—the Jonesville Business College and the Hadley Business Institute. The stock of the Jonesville Business College is owned by four persons. One of them is a hardware merchant devoting most of his time to that business, another is a street car conductor; the third is a retired capitalist. The fourth is an educator who devotes all of his time to the activities of the school. He owns one-fourth of the capital stock of the corporation and receives from the corporation a fair salary for performing his duties, among which is that of instructing advanced classes in bookkeeping. He has a corps of instructors under him and all are on a salary basis. The equipment is fairly large and is reasonably worth (net) \$10,000; that is, there is capital invested in the business to that amount.

The studentry is, of course, receiving personal service. The books and supplies are furnished to the students at cost. The principal, who is a stockholder, is rendering personal service as are all of the others of the faculty. Is this an invested capital corporation or is it a personal service corporation? It is not a personal service corporation, but is an invested capital or non-personal service corporation. What is the governing factor in this instance? It is not the fact that \$10,000 are invested in the enterprise. It is not solely because other teachers are employed. The main reason is that the principal stockholders do not render their personal services; the profits are not primarily the result of the activities of the owners.

If each of the three non-active stockholders devoted his time to the work of the school (one might be a solicitor of students, another might act as janitor, the third as teacher, or in some other capacity) then we should be inclined to place it in the personal service class. However,

this is not to be regarded as a conclusive test, as other factors may enter the equation that counteract this effect.

The Hadley Business Institute is a well-equipped school. The school occupies both floors of a two-story building worth \$30,000 and owned by the corporation. The equipment, while somewhat run down, is worth \$20,000. Ninety-five per cent of the stock is owned by A, B, C, and D; the other 5% is owned by outsiders. Mr. A is a noted specialist in commercial arithmetic. Mr. B is a high grade stenographic instructor. Mr. C is a teacher of bookkeeping and Miss D is an expert teacher of typewriting. These persons are in charge of the Departments in which they excel and each has one assistant. They also employ a solicitor of students. Also they have a small English Department, conducted by a hired teacher. Books and supplies are supplied to the students at cost.

Is the Hadley Business Institute a personal service corporation? It is. The profits of this school are attributable to the activities and reputations of the four main or principal stockholders. The fact that \$50,000 is invested is only incidental—irrelevant. The school could be conducted with little or no capital. The fact that the corporation owns the building is of no moment. A building could be rented—so could typewriters, etc. The incoming tuition would take care of current expenses.

Change of Ownership

The statement that if these persons were to sell the school to men of lesser reputation the prestige of the school would be materially lowered is not open to question. Therefore, the income is due, in great measure, to the activities and public estimate of the principal stockholders.

However, a change in ownership would not necessarily take a concern out of the personal service class. If the new

owners merely stepped into the shoes of the former owners and if operations went on about as before, the sale of the school would not affect its status. But if the new owners bought it as an investment, did nothing but merely supervise its activities, and even went so far as to employ as instructors the former owners, we should class the concern as a non-personal service or capitalistic corporation.

Frequency in change of ownership during a year should not affect the status, provided the conduct of the school remained practically the same as it was formerly.

Doing Part Personal Service

Now let us go a step further with the Hadley concern. We will assume that in addition to the facts given above, Mr. A wrote a text book on commercial arithmetic and that the school is publishing and selling it to other schools or to individuals, or that the building in which the school is located, and which the corporation owns, is an office building and a part of it is rented for office (or other) purposes. Or, we will assume that a boarding school is conducted and dormitories are rented to the students. It is manifest that now capital is no longer a mere incident to this business but has become a necessary factor in the production of income.

This phase of the matter has changed the status of the Hadley Business Institute from a personal service corporation to that of a corporation doing a part personal service business, and its tax must be computed upon a basis different from the computation of the tax of a personal service corporation or from that of a straight invested capital (or non-personal service) proposition, as will be explained later. Any corporation carrying on two or more lines of business, one or more of which requires the use of capital and one or more in which the employment of capital is not a necessity, must be classed as a non-personal

service corporation unless the total net income ascribable to the personal service branch or branches is equal to at least thirty per centum of the total net income of the corporation, in which case the tax of such net income shall be separately computed, as will be illustrated later.

No foreign corporation may be classed as a personal service corporation; neither may a corporation 50% or more of whose total gross income consists of gains, profits, or income derived from trading as a principal; nor may any corporation, 50% or more of whose gross income consists of gains, profits or commissions, or other income derived from a government contract entered into between April 6, 1917, and November 11, 1918, inclusive.

Tax Computations

The Jenner Sanitarium Company is owned and conducted by five noted physicians and surgeons. The only income is the fees paid by patients. The operating apparatus is owned by the corporation as is also the building it occupies, which is devoted wholly to the activities of the business. The only item the corporation sells is professional services. In 1918 the net income was \$30,000. At December 31, 1918, a dividend of \$20,000 was declared payable immediately. What is the corporation's tax liability for 1918? None, as a corporation, but the distributed or distributable share of each stockholder is taxable to the individual at the individual income tax rates.

Note that not only is the amount that was actually distributed to stockholders taxable, but also the amount that could have been distributed. This is a good example of the application of "constructive receipt." In this instance each stockholder (as an individual) would be required to pay a tax on \$6,000 in addition to the tax on any other income he might have.

If a portion (or all) of the year's earnings had been invested in additional facilities and little or nothing was received by the stockholders, the tax liability of the stockholders would not be lessened. What the Unit desires to know, primarily, is—"How much were the earnings for the taxable period?" What the taxpayer may have done with the earnings, either personally, or indirectly through the medium of the corporation's directors, is usually of interest only to the stockholders.

While personal service corporations pay a tax indirectly through the individual stockholders and the tax is assessed against the stockholders as individuals, the corporation must file a return and no deductions may be taken for donations made by the corporation. Thus if the book net income of the Jenner Company was \$45,000 and it had made a donation of \$5,000 to the Red Cross, each of the stockholder's taxable income would amount to \$10,000 in addition to any other taxable net income they might have, and none of the stockholders could deduct his proportion of the \$5,000 donation, although he could deduct (within statutory limitations) donations made by himself as an individual.

If, during 1918, this corporation made a distribution of earnings accumulated subsequent to February 28, 1913, and prior to January 1, 1918, for the purposes of the normal tax (but not of the surtax) the recipients of the dividend may deduct as a credit whatever portion of such dividend was received. The reason for allowing this credit is that the income tax was paid (doubtless) in the year for which it was earned.

Illustrating Part Personal Service

The Legal Advice Corporation is composed of several attorneys all of whom are very active in conducting the business, the principal part of which is the giving of coun-

sel and defending clients in litigation. Occasionally the corporation purchases a piece of real estate with the idea of later selling it at a profit.

In 1918 the total gross income of the corporation was \$100,000 of which \$75,000 is attributable purely to professional services and \$25,000 to real estate operations. The net profit ascribable to professional services was \$50,000 and the amount realized from real estate deals was \$10,000. This is a corporation doing a business that is part personal service and taxable as such. Had the gross income from trading been 50% or more of the total gross income, or had the net income from professional services been less than 30% of the total net income, we should have to tax this corporation at non-personal service corporation rates; in other words, the personal service element would be ignored.

The following illustration shows how the tax is computed with the respect of a corporation doing part personal service.

It is ascertained that the pre-war invested capital averaged \$30,000 of which \$20,000 was employed in real estate deals. The pre-war net income averaged \$45,000, of which \$15,000 is attributable to real estate activities.

We first compute the tax on that part of the business that is deemed non-personal service.

The specific exemption granted corporations is \$3,000. We allow in the case of a corporation doing part personal service, the proportion of this amount that bears the same relation to \$3,000 as does the real estate (non-personal service) net income to the total net income, or \$500. To this we will add 8% of the invested capital employed in the real estate business (say \$40,000 attributable to real estate and \$20,000 to personal service) or \$3,200, a total

exemption of \$3,700. The war profits credit is a specific exemption of \$500 (that is one-sixth of \$3,000) plus the pre-war average net income, \$15,000, plus 10% of the increase in invested capital for 1918 over that of the pre-war period (\$2,000), or a total war profits credit of \$17,500.

Schedule III—Excess and War Profits Credit

8% of invested capital.....	\$3,200
Exemption	500
	<hr/>
Excess profits credit.....	\$3,700
	<hr/>
Average net income for the pre-war period.....	\$15,000
Plus 10% increase in invested capital.....	2,000
Plus exemption.....	500
	<hr/>
War profits credit.....	\$17,500

Schedule IV—Brackets I and II

Not over 20% of invested capital \$8,000 minus excess profits credit=\$4,300 by 30%=.....	\$1,290
Over 20% of invested capital (10,000 minus \$8,000=\$2,000) by 65%=.....	1,300
	<hr/>
Excess profits tax.....	\$2,590

Bracket III

Net income for taxable year.....	\$10,000
Less war profits credit.....	17,500
	<hr/>
(No war profits tax)	

The above gives a tax of \$2,590, on a taxable income amounting to \$10,000 or a rate of .2590. This is the rate to apply to that portion of the income attributable to personal service.

$$\$50,000 \times .2590 = \$12,950.$$

To this amount must be added the \$2,590 tax found under Schedule III making a total war and excess profits tax of \$15,540.

Were the percentage obtained above less than 20%, the tax would be computed on the entire net income without regard to the personal element phase of the case. In such event we should, of course, allow not only the capital invested in the non-personal service part, but also the capital employed in the personal service branch of the business. Also, we should allow the entire exemption of \$3,000. In other words, it should be treated strictly as a capitalistic corporation.

The author believes this to be the correct interpretation of Section 303, and some very able auditors agree with him, while others take different views. The following is a view expressed by a member of the Technical Staff, whose view coincides with the view of the author:

"Section 303 apparently should be recognized only as a relief section. In such event it would not apply generally in the application of tax determination. Therefore, considering it in the form of furnishing relief for a taxpayer, it will be his privilege to take advantage of the section but only in so far as he is willing to comply with its provisions, because in any event the taxpayer desires to seek relief for the reason that he believes he is taxed under severe circumstances owing to the peculiar nature of his business that comes under the section which, of course, would cause the tax to be disproportionate.

"Knowing the above, it should be the duty of the taxpayer to comply with the law (section 303) as it is, and if he cannot do so the section would not afford relief which relief should then be sought elsewhere.

"In order, therefore, for a taxpayer to qualify for the relief intended it becomes necessary that certain arbitrary rules be met which in this case are specifically stated in the statute.

If the taxpayer cannot comply or meet the qualification as set forth then it becomes evident that the section is not intended for his benefit.

"If the taxpayer qualifies and the section is applied then the computation must sustain his contention in that the tax from a capitalistic source is 20% or over and in that way establish his rate for the Personal Service classification portion. It is safe to assume that the section intends to fix a line somewhere in order that the advantages of this relief section would not be abused.

"Now then, if the corporation cannot meet the arbitrary stipulations of the statute, although the corporation is partly capitalistic and partly Personal Service class, the remedy that will afford relief would be Sections 327 and 328.

"I believe that this section was purposely made restrictive in order to avoid abuse of same and really to furnish a form of relief for the difficult cases of capitalistic and Personal Service nature."

The following is an opposing view written by another member of the Technical Staff:

"It is stated in the text that 'were the percentage obtained above (the percentage of tax to the capitalistic income of the business) less than 20% the tax would be computed on the entire net income without regard to the personal service element——.'

"This would be denying the corporation the relief that it was intended Section 303 should give to a corporation doing part-personal service business.

"It is only in the event of the tax upon the whole income computed under section 301, being less than 20% that a corporation applying for taxation under section 303, shall be denied relief under the section.

"If the tax computed on the income from the first part (capitalistic) is less than 20%, and the tax on the whole in-

come (computed under section 301) is more than 20% then 20% should be applied to the second part. In other words, it seems reasonable to suppose that if the provisions of the statute state that in no case less than 20% shall be charged 20% must be charged if the computation results in a smaller percentage.

"The only condition (as regards percentage of tax) as stated above, upon which a corporation, applying for 303, is thrown back into 301, is where the tax on the whole income (under 301) is less than 20%."

Which View?

Which view is the auditor to accept? The author is very sure that the first view is correct, but he does not know that it is right. Those who take the opposing view also feel sure of their ground, but they admit as willingly as does the author that they do not know that they are right in their view.

This matter is being presented to the solicitor for an opinion and the only thing for you to do is to watch the Bulletins and when the opinion appears, erase such portions of this text as are contrary to the opinion given.

A Wrong Assumption

At first glance it may be thought that to arrive at a percentage as is done in the preceding problem and then to apply that percentage to the personal service portion would be failing to give the corporation doing part-personal service any advantage, in that the entire income—both non-personal service and personal service contributes tax at the same rate. The fallacy of this assumption will be clear by computing the tax on the basis that this is a non-personal service corporation.

Note the difference in the amount of tax resulting.

INVESTED CAPITAL ACCOUNTING

Schedule III

8% of invested capital.....	\$4,800
Exemption	3,000
	<hr/>
Excess profits credit.....	\$7,800
	<hr/>
Average income for the pre-war period.....	\$45,000
Plus 10% increase in invested capital.....	3,000
Plus exemption.....	3,000
	<hr/>
	<u>\$51,000</u>

Schedule IV

Not over 20% of (\$12,000—\$7,800=\$4,200) by 30% =	\$1,260
Over 20% of (\$60,000—\$12,000=\$48,000) by 65% =	31,200
	<hr/>
Excess profits tax.....	\$32,460
Net income for taxable year.....	\$60,000
Less war profits credit.....	51,000
	<hr/>
(No war profits tax).....	\$9,000x80%=\$7,200

You will note that the excess profits tax has jumped from \$15,540 to \$32,460 by reason of computing it on the non-personal service basis. To the profits tax must (as determined on page 9) be added the income tax, in the following manner:

Total profits tax.....	\$15,540.00
Net income for taxable year.....	\$60,000
Less: War and excess profits	
tax	\$15,540
Exemption	2,000
	<hr/>
Balance subject to income tax.....	\$42,460x12%=5,095.20
	<hr/>
Total tax assessable.....	<u>\$20,635.20</u>

In determining as to whether or not a corporation is personal service or non-personal service, no fixed rules can be laid down that would apply to the general run of cases but, usually, unless at least 80% of the outstanding stock is owned by those who actively conduct the business and whose personal efforts bring in most of the income, it must not be classed as a personal service corporation. However, the 80% limit is not a conclusive factor; there are instances where personal service has been established on a lower basis. Note that Article 1529 makes the 80% limit only with reference to filing returns "in the first instance." It is conceivable that a return "in the first instance" would be filed on a strict capitalistic basis and a claim then entered by the taxpayer for assessment under Section 303 which might be allowed.

Amount of Capital

To be classed as a non-personal service corporation, it is not necessary that the invested capital be even reasonably large. You will note that the Regulations do not require that there be any invested capital—but they do require that all corporations be classed as non-personal service if capital (note "capital," not "invested capital") is a material income-producing factor. Thus a concern may buy and sell coal in large quantities. The reputation and standing of the stockholders may be such that credit is granted in large amounts. It may never handle or see the coal. It may take the order of the customer and place the order with the mine and the coal is shipped direct to its customer and it may pay for it when the customer pays. It may need only enough invested capital to purchase a desk, install a 'phone and pay a month's rent (all of this could, conceivably, be done on credit). Nevertheless, it is not a personal service corporation. But, if it simply acted as agent for the coal; if the coal were billed by the mine to the customer; and if the corporation is not respon-

sible for the payment of the coal, it would become a personal service corporation even though it had invested considerable money in luxurious office fixtures, etc.

The first instance cited just above is a parallel of thousands of cases of people doing business where capital is necessary. The fact that a concern such as this (and it is not far fetched—the writer audited a very similar case) can do business without capital, is only incidental. It is a class of business in which capital is almost without exception necessary, and in deciding whether any case is personal service or non-personal service, if it is determined that the business is such as to require capital in its conduct, then it may not be classed as a personal service corporation.

A Further Illustration

Let us cite another hypothetical case. We will take the matter of the Clipper Barbering Corporation. It is composed of three stockholders—each owning one-third of the stock authorized.

The corporation has a very small amount invested, having been able to acquire the use of a large, well equipped shop at a fair rental. Being well and centrally located, a very large business is done. There are, in addition to the three stockholders (who are practicing barbers) twelve other barbers, two shiners and two porters. A return was duly filed and a claim was entered to the effect that the concern should be classed as a personal service corporation. Should this claim be allowed? No. The guiding reasons are:

- (a) Such business, of this apparent magnitude, ordinarily requires capital. In this case, rented capital is in use and if this rented capital were not employed, other capital would have to be employed. It is evident that in this case capital is a large

factor in the production of income. However, the mere fact that a very large volume of business is done is not, of itself, a determining factor.

- (b) That the stockholders do barbering is, in this instance, only incidental. The bulk of the income is the result of the labor of hired employees.
- (c) That the stockholders may actively direct the business at all times and in all ways has no bearing in this case, and, in fact is a determining element in very few, if in any cases.

Income from Royalties

The writer of this book was conferee in a conference with a taxpayer's representative in which the representative of the corporation claimed that his client should be assessed as a personal service corporation for the reason, as he said, "It was engaged neither in trading nor manufacturing,"—that all of the income was derived from royalties on patents; that no capital was needed to carry on the business; that all his client had or needed to carry on the business was a small office and one stenographer.

His claim was not allowed. He overlooked the fact that in order to receive income from the patents it was necessary for his client to own or exercise control of the patents and this ownership or control involved the use of capital, and that the income was the result of the employment of that capital. However, it is conceivable that royalties might be received from patents where there was no capital invested.

Whether capital was actually invested by the stockholders or was borrowed capital is irrelevant. Therein lies a marked difference between capital which may be stockholders' investment or it may be borrowed capital, and invested capital which consists only of capital which the

stockholders have actually put into the business, or of accumulated earnings which they have permitted to remain in the business free and unallocated in any way, save only as true surplus may be legitimately allocated to certain true reserves.

Royalties received from copyrights, etc., would be treated the same as royalties from patents.

A Peculiar Situation

Section 303, Regulations 45, stipulates that the tax imposed on the portion of the income derived from personal service "shall be the same percentage thereof as the tax so computed upon the first part is of such first part: Provided, That the tax upon such second part shall in no case be less than 20 per centum thereof, unless the tax upon the entire net income, if computed without benefit of this Section, would constitute less than 20 per centum of such entire net income, in which event the tax shall be determined upon the entire net income, without reference to this Section, as other taxes so determined under this title * * *."

Let us speculate a little. We will assume that a certain corporation claims to be doing part personal service business and that its claim meets all the tests required. We will also assume that the portion of the business that is non-personal service was conducted without profit—it just "broke even," but that there was a profit derived from the personal service branch of the business. How are we going to determine the percentage of tax to be applied to this latter branch? We cannot get the percentage as called for in Section 303, for no percentage is possible.

Tentative Answer to the Question

Section 303 tells us that the tax must be at least 20 per cent of the personal service income, unless the tax,

if computed with the benefits of Section 303, would be less than 20 per centum. It is evident that the law is not clear on this point, but it seems to some that this provision would help us out and it has been suggested that the only possible way of determining the amount of tax is to compute the tax without the benefit of Section 303 but compute the tax under Section 301 ignoring Section 303 altogether. However, in this procedure Section 302 would have to be borne in mind, and if it should apply, the tax computed must come within the limitations therein stated.

To go farther into this question let us assume that a loss was suffered in that portion of the business which was non-personal service. Shall we deduct the loss therein incurred from the profit derived from the personal service branch of the business? Neither the law nor the Regulations state definitely what to do.

But I do not believe that the procedure outlined above covers the case properly. I do not believe it is the correct procedure notwithstanding the fact that I have heard some able men uphold it. I believe that the first line of Section 303 points out the way. It is an axiom that a whole is greater than any of its parts, and that a part cannot equal a whole. Section 303 says "That if part of the net income * * * ." That is the only section authorizing a special tax on incomes derived from personal service. All other taxes on personal service are assessed against the distributive share of each of the stockholders. Now, if a corporation doing a part personal service business sustains a loss in the non-personal branch or just breaks even in that branch, then ALL of their net income is from personal service operations and Section 303 does not apply in so far as tax computation is concerned. The only way we have left to arrive at the tax of such a concern is to compute the tax on the same basis that we would compute the tax of a corporation doing nothing but personal service business.

CHAPTER SEVEN

CAPITAL STOCK—TREASURY STOCK

Caution

Before you begin the study of this portion of this book, accept a word of advice, which is: attempt to learn *only one* thing at a time, and the particular thing for you to learn *now* is the matter treated of in this chapter. Leave subsequent chapters alone until you *know* this one. Yes, one word further—do not speculate on hypothetic propositions; the subject of tax law is so full of stern, practical problems that you will be kept wholly occupied without entering into the realm of the visionary.

Before beginning the study of this chapter, it is advisable that you make a thorough study of Article 831, Regulations 45.

Capital Stock

In determining the invested capital of a corporation, our whole effort is to ascertain the amount of money the stockholders have invested in the corporation, and as the first step toward the accomplishment of this object, capital stock must be considered. There are various classes of stock, such as common stock, preferred stock, no-par value stock, or some modification of these terms, but by what title the stock may be labeled we care little; the question we want answered is: What did the corporation realize in dollar-value when it issued the stock?

We are not primarily interested in the amount of

capital stock authorized; it is the amount *issued* that is a more important factor. The mere fact that a given amount of stock is authorized does not indicate that it has been issued, and the fact that it has been issued does not necessarily imply that it is now *outstanding*—in the hands of stockholders—some of it, having been fully paid for, may have been returned to the treasury of the corporation, either by donation or through the giving by the corporation of some asset in exchange for the stock, thereby creating *treasury stock*.

Again, all of it may have been issued but not issued at par value. It is true that most states require that capital stock be issued at a price at least equal to par, but this is not universally the case, and there are various ways of evading the provisions of the law. Further, some states—a constantly increasing number—permit the issuance of stock of no-par value.

In some instances the stock of no-par value* may be issued for any price determined upon by the directors of the corporation. The price for which it is issued today does not necessarily set the price for which it may be issued tomorrow. In some states, however, a stated minimum value must be received for stock of no-par value. With these niceties of distinction we have at present no particular concern. They do raise interesting questions in general accounting practice but they do not materially enter into our present subject for the reason that we do not care what the particular present value of the stock is, nor the name by which the stock is known, and with the exceptions which will be cited later, we do not care to know how many shares have been issued. What we *do* care for, however, is: How much stock is actually outstanding and

*The author has in preparation a work entitled, "Stock of No-Par Value; Its Economic and Accounting Aspects." It is hoped to place it on the market early in 1923.

what amount of value, expressed in dollars, did the corporation receive for the stock issued? When we have arrived at this figure we shall have reached the first milestone on the road to invested capital—and invested capital is the money or its equivalent that the stockholders have *invested* in the enterprise or have allowed to *remain* in the enterprise in the form of surplus.

Note particularly that I have used the present perfect tense—"have invested." It might have been invested in the past and a portion or all of the investment may have been returned to the investor, prior to the taxable year, in which event it would not now be invested capital. Also, it must have been "invested"—present worth of the holdings, or market quotations have absolutely no bearing. The only point is—How much money (or its equivalent) did these stockholders take a chance in losing by investing in the capital stock of the concern and (or) by allowing actual net earnings to remain in the surplus of the corporation?

If stock is issued to the amount of \$100,000 and sells at par value, the invested capital, so far as the item of capital stock is a factor, is \$100,000. If it sold for more than par value, say at a premium of 20%, then the invested capital is \$120,000. On the Balance Sheet we should find—

<i>Assets</i>	<i>Liabilities and Capital</i>
Sundry Assets.....\$120,000	Capital Stock.....\$100,000
	Capital Stock Premium. 20,000
<hr/> \$120,000 <hr/>	<hr/> \$120,000 <hr/>

The Premium might be set up as some kind of Surplus, as is explained in Chapter Seven.

Assuming that the corporation is one issuing stock without par value; assuming further that it is authorized

to issue 10,000 shares, and that it has issued 1,000 shares at \$12 a share and that its Balance Sheet is substantially as follows:

<i>Assets</i>	<i>Liabilities and Capital</i>
Cash .....\$12,000	No-par value stock 1,000 shares issued for \$12 per share .....\$12,000
<u> </u>	<u> </u>
<u>\$12,000</u>	<u>\$12,000</u>

how do we determine the amount of invested capital?

It is evident from the above that the stockholders have precisely the same money invested in the business that they would have had had the corporation issued 120 shares having a par value of \$100, at par. In other words, their invested capital is what they have put into the business—\$12,000.

But suppose that shares were issued at different periods and at different prices per share, and suppose further that the concern also has outstanding common stock of a par value of \$100. Assume this to be the case with the corporation whose Balance Sheet has just been presented and that 1,000 shares of no-par value stock were issued for \$12 per share and 1,000 shares were issued for \$15 per share, and we have submitted to us something like the following:

<i>Assets</i>	<i>Liabilities and Capital</i>
Cash .....\$50,000	Common stock, par value \$100 .....\$100,000
Sundry Assets..... 77,000	No-par value stock, 10,000 shares authorized 2,000 shares issued for 27,000
<u> </u>	<u> </u>
<u>\$127,000</u>	<u>\$127,000</u>

The principle does not change; the various values for which no-par value stock was issued occasion us no trouble; if some were issued for one dollar a share and some of the same stock were issued for \$100 a share, the principle remains the same—how much value did *all* the stock bring in?—that's what counts—nothing else does.

The reader will now perceive that, in so far as invested capital is concerned, it matters not by what term the capital stock may be known, the *only* thing that counts is—*How many dollars' value did it bring to the corporation?*

Treasury Stock

It is the desire of the writer to emphasize as strongly as possible the fact that, so far as invested capital accounting is concerned, Treasury Stock *is not an asset*. We are fully aware that some able accountants do classify it as an asset, but regardless of what view you may hold on the question as regards general accounting practice, in your Income Tax work you must regard it as being a reduction of Capital Stock outstanding. In other words, there is only one place to put it on the balance sheet, and that is as a reduction of capital stock issued. I contend that Treasury Stock is *never* an asset in any phase of accounting, but this is not the place to discuss the question from the viewpoint of general accountancy.

Unissued Stock is *not* Treasury Stock, notwithstanding the fact that some corporations so classify it. Treasury Stock can only be stock that has been issued—outstanding—and *returned* to the treasury of the corporation. This may be brought about in a number of ways.

Working capital might be needed and the stockholders might return a portion of their holdings to the corporation, either as a gift or otherwise, for resale, and the returned stock would be shown on the Balance Sheet in one of the two ways that follow:

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$10,000	Notes Payable.....	\$150,000
Sundry Assets.....	440,000	Capital Stock	300,000
Treasury Stock.....	70,000	Surplus	70,000
	<u>\$520,000</u>		<u>\$520,000</u>

For invested capital purposes, the above is not a true statement. The second and better way is as follows:

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$10,000	Notes Payable.....	\$150,000
Sundry Assets.....	440,000	Capital Stock.....	\$300,000
		Less Treasury	
		Stock	70,000 230,000
		Surplus	70,000
	<u>\$450,000</u>		<u>\$450,000</u>

You will now see that Treasury Stock *must be deducted* from the total amount of stock issued to obtain the amount of stock actually outstanding.

The above is a true statement for invested capital purposes, and the invested capital would be the amount of stock outstanding plus the Surplus, or \$300,000, *provided*, that when the stock was originally issued the corporation received in cash or its *unquestionable equivalent* \$300,000 for it.

If the stock were issued for property, tangible or intangible, and a portion of the stock were returned to the corporation as a gift, or at a price "substantially less than its par value," then that portion of the stock is treated

as not having been issued for property—in other words, the property for which *all* the stock that was issued to the person who returns a portion of it is regarded as being worth not more than the par value of the stock *retained* by the donor, and any Surplus that has been set up as an offset to this fictitiously-valued property must be eliminated. Article 861. In such event, the true Balance Sheet would show—

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$10,000	Notes Payable.....	\$150,000
Sundry Assets	370,000	Capital Stock.....	\$300,000
		Less Treasury	
		Stock	70,000 230,000
	<u>\$380,000</u>		<u>\$380,000</u>

Thus we see that the actual invested capital under such conditions, is reduced to \$230,000. This adjustment, in connection with the reduction of Capital Stock, is the mis-named “double deduction,” a term that never should have been applied, owing to the fact that it has caused some to get a wrong impression. It is not a double deduction of any one thing. There is a reduction of Capital Stock and an adjustment of Surplus to its true amount.

Had this stock originally been issued for cash, at its par value, no Surplus adjustment would be required.

Under Schedule E, line 3, would be entered the amount of Capital Stock set up by the corporation. If any of this stock had been issued at a premium, the excess over the par value would be entered in line 5. If there were any Treasury Stock carried as an asset, the amount of same should be placed in line 9.

Note that line 9 says, "Deduct cost of Treasury Stock (or book value if different from cost)." If it cost the corporation nothing, that is, if it was "returned as a gift, or for a consideration substantially less than its par value," and the corporation carries it as an asset at par value, or at any other figure, deduct the book value; not the cost (to the corporation) of the stock. This takes care of the Treasury Stock deduction, but it does not make the necessary adjustment to Surplus. Refer to Form 1120, G2 for 1919. The answer to both questions under G2 being "yes," in this particular instance, we should have a statement something like this:

(a) Sundry assets	
(b) At organization	
(c) Par value of stock (assume that donor was issued stock amounting to \$150,000)	\$150,000
(d) Actual cash value of property when paid in....	80,000
(e) Cost less depreciation	
(f) Value entered on books.....	150,000
(g) Excess value.....	70,000

Manifestly this might be an adjustment of Surplus, since Surplus is unduly increased by \$70,000, but the Form does not so provide. However, the correct result is obtained by entering the amount in line 2, Schedule G.

Valuation of Property Received for Stock

It is generally conceded that one of the prerogatives of a board of directors is the right to place a value on property for which stock is issued and, unless fraud can be shown, this valuation will be permitted to remain on

the books of the corporation, but, for invested capital purposes, it does not follow that the corporation will be permitted to set up that amount, or that value, as a basis for computing invested capital. Therefore, if a business, or other property is purchased and, let us say, \$500,000, par value, stock is issued therefor, it does not necessarily mean that the corporation shall be allowed invested capital to that amount solely because of the fact that it has outstanding Capital Stock to the amount of \$500,000 and that it carries the acquired assets at \$500,000.

If, upon investigation, it be found that the property taken in exchange for stock was worth the par value of the stock issued for it, then we must allow the full amount. If it be found that the property is worth less, then we would allow invested capital, in so far as Capital Stock is a factor, only to the extent of the actual cash value of the property at the time acquired. Whatever the deduction might be should be entered on line 2, Schedule G.

To make the matter more patent, as well as further to illustrate the matter of Treasury Stock deduction, we shall take the Balance Sheets of Corporations A, B, C, D, and E, which are similar as to items and amounts, except that Surplus requires different treatments according as the stock was issued for cash, for property at actual cash value, for property at an inflated value, and where Treasury Stock is carried by the corporation. (We shall ignore any statutory adjustments to invested capital that are not called for in the problems, in order to illustrate the various Balance Sheets and other conditions as above specified).

Corporation A issued its stock for cash, at par. The following is its—

BALANCE SHEET

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$50,000	Notes Payable.....	\$100,000
Plant	200,000	Capital Stock.....	300,000
Sundry Assets.....	250,000	Surplus	100,000
	<u>\$500,000</u>		<u>\$500,000</u>

No adjustments are necessary. The invested capital is the amount of Capital Stock, plus Surplus—\$400,000.

Corporation B issued its stock, part for cash and part for plant. The amount issued for cash was \$100,000. The amount issued for plant was \$200,000. It is agreed that the plant was actually worth this amount at the time of acquisition.

No adjustments are necessary; the invested capital is Capital Stock, plus Surplus—\$400,000.

Corporation C issued all of its stock for plant and other tangible property. It is found that the property received for the stock had an actual cash value at the time of acquisition, of \$225,000. The difference between this amount and the amount of stock issued therefor, must be deducted and should appear in line 2, Schedule G. The result is to allow Corporation C an invested capital of \$325,000.

In the case of Corporation D, Capital Stock was issued at par value, for cash, and later, \$75,000 of the stock, par value, was purchased by the Corporation at par value, and carried on the books as Treasury Stock. This is its—

BALANCE SHEET

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$50,000	Notes Payable.....	\$100,000
Treasury Stock.....	75,000	Capital Stock.....	300,000
Plant	200,000	Surplus	175,000
Sundry Assets	250,000		
	<u>\$575,000</u>		<u>\$575,000</u>

On the basis of the above Balance Sheet the corporation might, and probably would, claim an invested capital amounting to \$475,000, but that amount can not be allowed. We must deduct the Treasury Stock, leaving an invested capital of \$400,000. This gives Corporation D the same amount as was given Corporation A, and, since the assets are the same, and the liabilities are the same, it must be the correct amount. At any rate, it is equitable treatment.

We have just stated that the assets of Corporations A and D are the same, and you may think this statement is erroneous, inasmuch as one Balance Sheet shows assets amounting to \$500,000, while the other presents apparent assets amounting to \$575,000. A study of a corrected Balance Sheet for Corporation D will remove this impression:

<i>Assets</i>		<i>Liabilities and Capital</i>		
Cash	\$50,000	Notes Payable.....	\$100,000	
Plant	200,000	Capital Stock.....	\$300,000	
Sundry Assets	250,000	Less Treasury		
		Stock	75,000	225,000
		Surplus		175,000
	<u>\$500,000</u>			<u>\$500,000</u>

It should now be evident that the actual invested capital of Corporation D is \$400,000, and that, for invested capital purposes, Treasury Stock can not be treated as an asset; that the amount of stock outstanding is the amount of stock issued LESS the stock returned to the Corporation (whether by purchase or by gift).

And now we come to the so-called "double deduction"—the case of Corporation E. Its stock was issued under conditions exactly analagous to that of Corporation C, and \$75,000 of the stock was bought back at a nominal figure

(that is, at a price "substantially less than its par value") or it was returned to the corporation as a gift. The following is the—

BALANCE SHEET OF CORPORATION E

<i>Assets</i>	<i>Liabilities and Capital</i>
Cash .....\$50,000	Notes Payable.....\$100,000
Treasury Stock..... 75,000	Capital Stock..... 300,000
Plant .....200,000	Surplus 175,000
Sundry Assets .....250,000	
<u>\$575,000</u>	<u>\$575,000</u>

Is it not clear that if we do not make the second adjustment—an adjustment to Surplus—that we will be allowing Corporation E a greater amount of invested capital than was granted to Corporation C, notwithstanding the fact that the latter carried no Treasury Stock? Of course, that would be inequitable. The deduction must be made as to Treasury Stock, and, since the property acquired for stock was not worth the par value of the stock issued therefor, a second adjustment also must be made, as follows:

Schedule II—Invested Capital

	Taxable Year
Line 1 (see Form 1120) for'd from Schedule E....	\$400,000
Line 4 From Schedule G.....	75,000
Line 9 Invested Capital.....	<u>\$325,000</u>

Schedule E

Line 3.....	\$300,000
Line 5.....	175,000
	<hr/>
	\$475,000
Line 9.....	75,000
	<hr/>
	<u>\$400,000</u>

Schedule G

Line 2.....	\$75,000
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If the corporation had purchased the Treasury Stock at, let us say, 75% of its par value and it carried this stock as an asset at the amount paid for it, then the amount paid (which in this instance would be the book value) is the amount to be deducted and entered in line 9, Schedule E, and not the par value. See Article 862.

If the Treasury Stock was acquired by gift, or at a price "substantially less than its par value," and if the corporation can show to the satisfaction of the Commissioner that the property for which the stock was issued was actually worth the par value of the stock issued, it would appear that the second adjustment would not be made. But the burden of proof would be wholly upon the corporation and the evidence would have to be conclusive. The writer is unable to cite any authority for the above statement, but inasmuch as it would be nothing more than fair treatment, it is believed that such procedure would be sanctioned. Of course, if the reacquired stock was paid for in cash, there can be no question as to allowing the corporation to set up a Paid-in Surplus equal to the amount of cash that was received for the stock.

Value Greater Than Par Value of Stock Issued Therefor

Take the case of a close corporation, organized before any one dreamed of an excess profits tax. Four men, for example, own a business as partners. They decide to incorporate. The plant is worth, in cash, \$1,000,000. Each owns a one-fourth interest. So far as they might be concerned, it would be immaterial whether their holdings were represented by one share of stock the par value of which was \$10, or by 2,500 shares at a par value of \$100. Each would draw one-fourth of the profits in the shape of dividends. But they incorporate, let us assume, in 1910, for \$200,000 and issue to themselves stock to that amount, each receiving \$50,000 in stock, and the business is transferred to the corporation. Nothing affects them in the least until the advent of Excess and War Profits taxes, when it at once becomes desirable to show as large an invested capital as possible. They simply had incorporated for \$200,000 and turned their plant over to the corporation for \$200,000 in stock. No Surplus was set up. They did not feel any necessity for so doing. But now, in 1919, they wish to set up a Paid-in Surplus, based on the actual value of the plant as at the time that the corporation acquired it, less fair depreciation. Shall it be permitted the corporation to do this? Yes! The corporation has the same right to do this as the Government would have to reduce the surplus that some other corporation had set up and which surplus was based on an inflated or an appreciated value. This adjustment should be made in Schedule F. Study Articles 836 and 837; also 840 and 843.

Before allowing any such surplus to be included in invested capital, care must be taken to see that all actual depreciation, depletion, and (or) obsolescence has properly been charged off from the date of acquisition of the property down to the beginning of the taxable year. Also, that any deficit, other than an operating deficit (see Digest No.

9, page 193—1-19-129), that may have occurred has been made good. The subjects of depreciation, etc., are covered in subsequent chapters.

Partially-Paid-for Stock

Sometimes corporations sell stock to employees, officers, or others, to be paid for on the installment plan, which installments, in the case of employees or officers, are usually deducted from the weekly or monthly salary. It is seldom that the stock is actually issued before the full amount has been paid. But, regardless as to whether or not the stock actually has been issued, the amount that can be included in invested capital is the amount that the subscriber has actually paid on the contract, regarding "paid" as being the amount legitimately deducted from the pay envelope, and being based on a salary or wage figure that is not excessive for the kind or class of services performed by the subscriber.

In the event that an enforceable note or other obligation has been accepted by the corporation in lieu of cash payment of stock, the obligation, whether or not it bears interest, is regarded as payment for the stock; provided, that the jurisdiction under which the concern is incorporated permits the taking of such obligations in payment of stock, and, also, provided that the payment of the note or other obligation is not in any manner contingent upon the earnings of the corporation. See Article 833. Unpaid subscriptions to capital stock do not constitute invested capital. If the notes that are given in payment of stock are non-interest bearing, the amount allowable would be the actual cash value of the notes; that is, the discount value of the notes.

Bonus Stock

Capital stock is sometimes issued as a bonus in connection with the sale of the bonds of a corporation. To determine the amount to be included in invested capital (always remembering that borrowed money, whether in the form of bonds, or otherwise, can not be made a part of invested capital) ascertain the amount the corporation could have realized from the sale of the bonds had no bonus stock been given with the bonds. The difference between this amount and the amount for which the bonds and the stock was sold, is the measure of the value received for the bonus stock, and that amount may be included in invested capital.

For example, the X Corporation issues 50 bonds having a face value of \$1,000 each. With each bond it gives, as a bonus, one share of its capital stock, par value \$100. The amount received for the bonds thus issued is, let us say, \$40,000. Upon investigation, we find that without the bonus stock feature, the bonds would have brought \$38,000; hence, the invested-capital value to be placed on the \$5,000 capital stock given with the bonds is \$2,000. See Article 832.

Stock Dividends

Stock dividends do not affect invested capital. See and study Articles 859-860. Why? Assume a Balance Sheet something like this—

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$100,000	Accounts Payable.....	\$75,000
Accounts Receivable	50,000	Capital Stock Outstand-	
Plant	200,000	ing	125,000
Sundry Assets	150,000	Surplus	300,000
	<hr/>		<hr/>
	\$500,000		\$500,000
	<hr/>		<hr/>

No divergent question entering into the above, the invested capital is \$425,000, Capital Stock plus Surplus. Now a stock dividend is declared and issued. Surplus is charged \$200,000 and Capital Stock is credited with a like amount and then the Balance Sheet reads thus—

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$100,000	Accounts Payable.....	\$75,000
Accounts Receivable	50,000	Capital Stock Outstand-	
Plant	200,000	ing	325,000
Sundry Assets	150,000	Surplus	100,000
	<hr/>		<hr/>
	\$500,000		\$500,000
	<hr/>		<hr/>

Invested capital is still \$425,000—Capital Stock plus Surplus. All that has happened is to reduce one account and increase another—both being on the same side of the Balance Sheet.

More About Treasury Stock

(a) If at any time during the taxable year a corporation sells Treasury Stock which it held at the beginning of the period, or which it may have acquired during the period under review, the proceeds (here, par value has no significance) of the sale are to be included in invested capital, effective as of the date of the sale.

(b) If at any time during the taxable year a corporation acquires its own stock, invested capital for the taxable year must be reduced in an amount equal to the amount that the corporation paid for the stock, effective as at the date of purchase; provided, however, if at the time of purchase, there were undivided profits over and above the accrued income and profits taxes for the taxable

year sufficient to purchase the stock, then invested capital is not deemed to be subject to reduction by reason of the purchase by the corporation of its own stock. If the free earnings (undivided profits) are partly sufficient to cover the cost of the stock purchased, then invested capital is to be reduced to the extent that the available earnings are not sufficient to make the purchase.

Note that in this connection, par value has no bearing; it is the cost (to the corporation) of the stock against which the earnings are to be applied. See Article 862. If, however, as previously explained, the corporation acquired the stock prior to the taxable year, and carries it as an asset at an amount different from the cost, the amount of deduction is the book value.

To illustrate: (a) Corporation X sells, September 3, 1918, \$50,000 of its Treasury Stock for \$30,000. This amount (\$30,000) is added to invested capital for a period of 120 days, hence—

$120/365 \times \$30,000 = \$9,863.02$, the average amount to be added to invested capital.

(b) September 3, 1918, the Y Corporation purchased 300 shares of its own stock, par value \$100, for \$32,000. The earnings up to that date amounted to \$67,000. A dividend of \$10,000 had been paid July 1. The accrued income and profits taxes amounted to \$12,000.

Earnings up to date of purchase.....	\$67,000
Less dividend paid July 1.....	\$10,000
Less accrued taxes.....	12,000 22,000
Available for purchase of stock.....	<u>\$45,000</u>
Cost of stock.....	\$32,000
Earnings available.....	<u>45,000</u>

The earnings available being sufficient to cover the purchase, no deduction from invested capital is required.

(b-2) September 3, 1918, the Z Corporation purchased 300 shares of its own stock, par value \$100, for \$32,000. The earnings up to that date were \$48,000. A dividend of \$18,000 had been paid July 1. The accrued income and profits taxes amounted to \$20,000.

Earnings up to date of purchase.....	\$48,000
Less dividend paid July 1.....	\$18,000
Less accrued taxes.....	20,000
	<u>38,000</u>
Available for purchase of stock.....	<u>\$10,000</u>
Cost of stock.....	<u>\$32,000</u>
Earnings available.....	<u>10,000</u>
Invested capital reduced.....	<u>\$22,000</u>

Inasmuch as invested capital was reduced for a period of only 120 days, we must find the average reduction for the year, as follows:

$120/365 \times \$22,000 = \$7,232.88$, the average amount by which invested capital must be reduced by reason of this purchase of Treasury Stock. See Articles 853 and 854 (b).

Equality of Treatment

A number of auditors have held the view that to give more invested capital to a concern whose stock was returned as a gift than would be given to one that purchased the stock (all else being equal) would not be equitable treatment. This view can only be premised on the thought that when a concern buys in its own stock the transaction would be analogous to the purchase of some other thing, as a machine, or a building.

The underlying misconception is the result of erroneously regarding Treasury Stock as an asset. When a

machine is purchased, one asset is exchanged for another and the investment of the stockholders is unchanged. When Treasury Stock is purchased, an asset goes *back to the stockholder* in exchange for a stock certificate that has no more intrinsic value than has unissued stock.

The following illustrations may clear the matter up:

Balance Sheet of Corporation M before purchase of its stock—

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$100,000	Notes Payable.....	\$90,000
Accounts Receivable....	50,000	Capital Stock	250,000
Plant	350,000	Surplus	160,000
	<u>\$500,000</u>		<u>\$500,000</u>

The invested capital expressed by the above is \$410,000.

It is understood that in the illustrations below, the stock was issued for cash at par, and that the assets are stated at true value.

Now we shall assume that Corporation M purchases \$50,000, par value, of its capital stock, and this journal entry is made—

Treasury Stock.....	\$50,000
Cash	\$50,000
(Suitable explanation)	

Its Balance Sheet will now be as follows:

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$50,000	Notes Payable.....	\$90,000
Accounts Receivable	50,000	Capital Stock..	\$250,000
Plant	350,000	Less Treasury	
		Stock	50,000
		Surplus	160,000
	<u>\$450,000</u>		<u>\$450,000</u>

The invested capital is now \$360,000. It should be clear to you that when the stock was acquired cash went out—\$50,000 that had been invested by stockholders was *returned* to them, and is no longer invested in the enterprise.

In the following illustration we assume that the Treasury Stock was donated to the corporation, and that the following (or a similar) journal entry was made:

Treasury Stock.....	\$50,000
Donated Surplus.....	\$50,000
(Suitable explanation)	

The Balance Sheet would reflect the following:

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$100,000	Notes Payable.....	\$90,000
Accounts Receivable	50,000	Capital Stock..	\$250,000
Plant	350,000	Less Treasury	
		Stock	50,000 200,000
		Surplus	160,000
		Donated Surplus.....	50,000
	<u>\$500,000</u>		<u>\$500,000</u>

The invested capital is \$410,000 for the reason that when the Treasury Stock was acquired, nothing that had been invested by the stockholders was returned to them.

If this Treasury Stock is later sold, the invested capital will be increased by the amount realized from the sale, prorated as at the date of sale.

Capital Stock Averaged

In the event that during the taxable year a corporation issues additional stock, the amount received for the additional stock issued is to be added to invested capital as at the date of issue. Assuming that the M Corporation issued additional stock in the amount of \$80,000, at its par value, \$100, September 3, 1919, the amount received (\$80,000) is added to invested capital for a period of 120 days, hence—

$120/365 \times \$80,000 = \$26,301.37$, the average amount to be added to invested capital for the year, by reason of the issuance of this amount of additional stock. See Article 853.

Fraction of a Year

This feature is so clearly covered by Article 855 that further observations are deemed unnecessary. You should make a careful study of this Article and work out the illustration.

Borrowed Capital

It can not be too frequently asserted that borrowed capital can not be included in invested capital.

Some taxpayers are very clever in their efforts to convince us that borrowed capital should be considered, in their particular case, as invested capital. A case comes to mind: a man owning 99% of the capital stock of a corporation, borrowed from his bank, in the name of the corporation, \$35,000 and gave, individually, as security for the payment of the loan, a first mortgage on his residence property. He contended that, to all intents and purposes, this property was an asset of the corporation and should be so regarded by the Bureau, inasmuch as this property was the means whereby the corporation was enabled to procure the loan; that so long as this mortgage remained unpaid he could not sell the property and realize anything on it himself,

and, further, that in case the loan was not paid by the corporation, the bank could foreclose on the mortgage and sell the property for the corporation's debt; that since the property was pledged for the payment of a debt owed by the corporation, it was a corporation asset just as much as any item carried on the Balance Sheet of the corporation that might be pledged for the payment of a loan. It sounds plausible, does it not? His contentions were not looked upon favorably. The \$35,000 was borrowed capital, and not invested capital.

Gain or Loss in the Sale of Capital Stock

If a corporation sells its own stock below the par value of the stock, there is no deductible loss by reason of the transaction, and, per contra, if a corporation sells its own capital stock at a price above the par value of the stock, no taxable income is to be returned by reason of the transaction. See Articles 542 and 563. Note particularly that Article 542 states: "The proceeds (not the par value) from the original sale by a corporation of its capital stock * * * constitute the capital of the company."

Capitalizing a Bargain

In the event that a corporation secures, directly or indirectly, as through its stockholders or through an agent acting for it, property at a bargain price (actual bargain or presumed-to-be-bargain), as, for example, at a foreclosure, or other forced sale, a Paid-in Surplus may not be set up on the basis that the property was worth more than it cost the corporation. In other words, you cannot capitalize a bargain. Article 836. But see also, and study Article 837. Always bear in mind that *cost to the corporation* is the determining factor.

The Meat in the Coconut

The whole matter as to whether any given item is to be regarded as invested capital or as borrowed capital, resolves itself into this question: Does the obligation take precedence over, or stand on an equality with, general creditors? If it does, then it must not be classed as invested capital; otherwise, it is pretty safe to include it in invested capital.

Of course, all questions regarding invested capital may not be summed up in the above question, but any question having to do with proprietorship money, and with creditorship money, may be decided on the basis of the formula given.

Things to Remember

1. The value, in dollars, that a corporation receives for its stock, is the amount of invested capital that is contributed by the Capital Stock of the corporation.
2. Treasury stock may not be regarded as an asset, and is not considered as being "stock outstanding." And, further, when Treasury Stock is purchased by the corporation, a portion of the contribution mentioned under 1, above, goes out.
3. Any change made in the amount of stock outstanding during the taxable year, must be averaged as at the date of the change.
4. Borrowed capital is not invested capital.
5. The sum of the assets can not be regarded as being the measure of invested capital. Under only one condition does the invested capital and the sum of the assets form an equation, and it is far from

likely that you will ever have occasion to audit such a case.

6. Stock returned to the treasury as a gift, or at a price "substantially less than its par value," and having been issued for property, tangible or intangible (these will be explained in the chapter on Tangibles and Intangibles), is regarded as not having been issued for property. Not only is the amount of Treasury Stock to be deducted from the amount of stock issued, to obtain the amount of stock outstanding, but Surplus must be reduced by the amount of inflation brought about by the inflated value placed upon the property received for the stock.

CHAPTER EIGHT

SURPLUS—RESERVES—FUNDS

Importance of Surplus

The most important factor in building up invested capital is Capital Stock—how much did it contribute to the business? The item next in importance, in fact, the only other item of great consequence, is Surplus—how did a given amount find a place on the balance sheet; did it get there by the directors allowing a part of the concern's actual corporate earnings* to remain in the business, or through contributions of stockholders (or, perhaps, by others) in *excess* of the par value of the stock issued to them? If so, it is a part of invested capital. If it got there in some other way, as for example, by inflation of asset values, by writing up assets to actual present value, by the arbitrary creation of good will, by failure to record certain liabilities, by failure to charge off sufficient depreciation or other proper expenses, or by any other means the portion of Surplus so created can not be included in invested capital.

What is Surplus?

Surplus is the excess of assets over the total of liabilities plus the amount of Capital Stock outstanding.

Conceivably there could be an actual Surplus and at the same time it might not be in evidence on the balance

*Note the use of the term "corporate earnings," instead of "net operating income." The former rightfully would include "non-operating income."

sheet. Such a condition could arise in the case of a corporation issuing stock of no-par value. Assume that the X Corporation has outstanding 5,000 shares of no-par stock for which it received \$60 a share. During past periods it has allowed net earnings amounting to \$25,000 to remain in the business. Some bookkeepers would credit the stock account with the earnings, showing a balance sheet somewhat like the following:

<i>Assets</i>	<i>Liabilities and Capital</i>
Cash .....\$50,000	Accounts Payable.....\$25,000
Sundry Assets .....300,000	No-par Value Stock 5,000 shares outstanding.....325,000
<u>\$350,000</u>	<u>\$350,000</u>

Such technique is very bad, but since we have no control over the bookkeepers, we cannot dictate to them how they shall keep their books. When there is a surplus it should be shown as a separate account precisely as it would be shown were the stock of the usual par-value variety, thus—

<i>Assets</i>	<i>Liabilities and Capital</i>
Cash .....\$50,000	Accounts Payable.....\$25,000
Sundry Assets.....300,000	Capital Stock—5,000 shares of no-par value issued for.....300,000
	Surplus 25,000
<u>\$350,000</u>	<u>\$350,000</u>

Broadly speaking, there are two kinds of Surplus—Earned Surplus and Paid-in Surplus. Other terms are sometimes used, such as Donated Surplus, Capital Surplus, etc. Usually, Surplus is included in invested capital, but not necessarily so; neither need all of it be included, as we shall see as we go along.

For invested capital purposes, Earned Surplus may consist of earnings accumulated during the period or periods preceding the taxable year, and (or) of profits realized from the sale, previous to the taxable year, of capital assets. Occasionally, it may come from other sources, as, for example, insurance received in excess of the actual loss to the corporation.

From the viewpoint of good accounting practice, a distinction should be made between earnings and profits as here mentioned, but for our purpose, this technical distinction need not be observed. Study Article 838.

Paid-in Surplus, real or so-called, may be the result of various transactions, such as—

- (1) If the capital stock be not non-assessable, an assessment might be made on the stockholders for the purpose of procuring working capital, or, the stockholders might voluntarily contribute to a working fund. See Article 543.

To illustrate, stock outstanding might be \$500,000. The corporation needs ready cash and the stockholders are assessed, or voluntarily pay in, 50% based on the holdings of each, after which the Balance Sheet might appear something like the following:

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$300,000	Notes Payable.....	\$100,000
Sundry Assets.....	600,000	Capital Stock.....	500,000
		Paid-in Surplus	250,000
		Earned Surplus.....	50,000
	<u>\$900,000</u>		<u>\$900,000</u>

- (2) The original sale of Capital Stock might be at a price above par, in which event the amount realized above the par value of the stock would be Paid-in (or Contributed) Surplus—sometimes called Capital Surplus. Possibly it would appear on the Balance Sheet as Premium on Capital Stock, as—

Assuming that 2,000 shares of a certain stock, having a par value of \$100 a share was sold by the corporation at \$120. We should find on the books something like this:

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$50,000	Accounts Payable.....	\$60,000
Sundry Assets.....	250,000	Capital Stock.....	200,000
		Paid-in Surplus.....	40,000
	<u>\$300,000</u>		<u>\$300,000</u>

But note this: Transfer of stock or shares between parties neither of whom is the corporation, does not affect invested capital no matter how much the stock may bring above par or how much below par. The only time that the amount the stock brings, has any bearing on invested capital is when that amount is paid directly to the corporation. One may pay to a stockholder \$200 for

a share having a par value of \$100 and such a one has invested \$200 in that share of stock, but the corporation did not receive the invested sum. Its invested capital is based on what the original holder of the share gave for it to the corporation.

If one pays \$200 for a share of stock having a par value of \$100 there must be some reason for paying such a premium. The usual reasons are—

- (a) Earning power of the corporation resulting in an unusually large dividend percentage.

Big earning power does not affect invested capital unless the earnings remain in the business, and even then, the invested capital for the year in which the earnings are realized is not affected, but the succeeding year's invested capital would be, provided, as stated, that the earnings remain in the business, either as Surplus or as Surplus charged with a stock dividend.

- (b) A big excess of assets over capital stock and liabilities, resulting in a large surplus.

Since Earned Surplus is included in invested capital it might be said that the \$200 paid for a \$100 share is invested capital—\$100 represented by the stockholder's equity in the Surplus. The invested capital, however, has not been changed by the payment (to a stockholder) of \$200 for a \$100 share—the investment was there before the transfer of stock.

- (c) A desire to obtain control of the concern.

In this instance a great difference is apparent. Assume first, Mr. H. can control corporation Y by becoming the owner of ten addi-

tional shares of stock. He buys the shares from Mr. J. and pays \$10,000 for the ten shares the par value of which is \$1,000. Invested capital is not changed. Second assumption: There are ten unissued shares, or there are ten shares of Treasury Stock and Mr. H. pays \$10,000 for them. Invested capital is increased by \$10,000 as at the date of sale of the shares. In either event the money was invested by Mr. H, but in the first instance it did not go into the business; under the second assumption, the money went into the treasury of the corporation.

- (3) In some instances it might consist of gain derived from the redemption of the corporation's bonds at a price less than the selling price, or in bonds being donated back to the corporation by the purchaser.
- (4) Infrequently it may be found that Surplus is the result of the forfeiture of stock partly paid for. It sometimes happens that purchasers of stock, failing to carry out the agreement, forfeit their right to the stock, and to whatever amount they may have paid on it. The amount they had paid on the stock, in this event, would become Paid-in Surplus.

In many of the states this could not happen for the corporation would be required to pay to the original subscriber any excess. Thus, to illustrate, B pays \$4,000 in installments on Stock Purchase Contract calling for \$10,000 and defaults on the balance. The corporation sells the stock to C for \$8,000. Under the laws of some states there would be created Surplus by Default, \$2,000. In other states the corporation would have to return \$2,000 to the original subscriber.

- (5) This subdivision has to do with Surplus created by the return of Capital Stock as a gift. This matter is covered in the chapter on Capital Stock.
- (6) Certain of the assets might actually have appreciated in value, or their value might have been arbitrarily written up. The book value (real or supposititious) over the cost of the asset would be a credit to the so-called Paid-in Surplus. Or, since there is no standard accounting terminology for such items, this supervalue might be credited to an account called Earned Surplus. That would not be good accounting procedure.

The items (1), (2), (3), and (4) are properly included in invested capital. Surplus created as under (6) must not be included in the computation of invested capital. Item (5) is explained in Chapter Seven. Study the article in Bulletin 18-20, page 17.

Divisions of Surplus—Reserves

All of the actual Surplus is not always embraced within the terms or names previously mentioned. Undivided Profits is, in effect, Surplus for invested capital purposes. Do not fail to observe, however, that the account, Undivided Profits, must receive the same close scrutiny that should be accorded to Surplus. It is just as easy to make entries showing erroneous undivided profits as it is to make entries that will produce an overstated Surplus.

All true reserves are mere bookkeeping divisions of Surplus—Surplus set aside for some definite purpose—and must be included in invested capital.

Note the designation, TRUE RESERVES. All accounts labeled "reserves" are not true reserves. Many of them are not reserves at all. A True Reserve is an allocation of Surplus. or, as it is sometimes called, Appropriated Sur-

plus. Some reserves, while they may appear to be allocations of Surplus, are in actuality, Valuation Accounts, or, Suspended-Credit Reserves.

Bear this in mind—a TRUE RESERVE is properly reflected on the asset side of the Balance Sheet in assets of equal value. Any other reserve (so-called) should indicate to you that the values of the assets are overstated.

The most glaring misuse of the term “reserve” is in the account, Reserve for Depreciation. Its misuse is all the more unfortunate because of its almost universal adoption to represent something that is not an actual liability; it is not Net Worth; but it is often found on the Liability-Net Worth side of the Balance Sheet.

What it really is, is hard to define, but its true function is to reduce, instead of reflect, the values shown on the asset side. By some accountants it is called a Negative Reserve (it is negative, but it is not a reserve). By other accountants it is called a Suspended-Credit Reserve. These names are seldom given the account by bookkeepers—they are applied by accountants in their struggle to find an appropriate name for the account. The Interstate Commerce Commission requires that the term, Accrued Depreciation, be used. For reasons not necessary to mention here, this appellation is objectionable.

It is true that there might, or could, be a TRUE Reserve for Depreciation; that is, functional depreciation—almost equivalent to Inadequacy or Obsolescence, but such a reserve is seldom seen on a Balance Sheet.

Practically all accounts called Reserve for Depreciation are not reserves at all. They should be regarded as Allowances for Depreciation. The word “allowance” exactly expresses the status of the account. A Reserve for Depreciation, as ordinarily set up, has the effect of indicating a false (inflated) value or amount of assets. This

will be evident to you if you will carefully compare the two Balance Sheets that follow:

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$300,000	Notes Payable.....	\$100,000
Buildings	80,000	Capital Stock.....	500,000
Sundry Assets	520,000	Reserve for Depreciation	10,000
		Surplus	290,000
	<u>\$900,000</u>		<u>\$900,000</u>

The impression conveyed to the average person, by the above Balance Sheet, is that the assets are worth \$900,000. This is an erroneous conception. This Balance Sheet does not present a correct statement of value. There is nothing to show that the Reserve for Depreciation is not a true reserve for contingent (functional) depreciation, while, as a matter of fact, in this, as well as in a vast majority of Balance Sheets, it is intended to reflect actual, sustained depreciation of past time. See Articles 844 and 840 (1).

A Better Way to Set up the preceding Balance Sheet:

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$300,000	Notes Payable.....	\$100,000
Buildings	\$80,000	Capital Stock.....	500,000
Less allowance for Deprecia- tion	10,000 70,000	Surplus	290,000
Sundry Assets	520,000		
	<u>\$890,000</u>		<u>\$890,000</u>

In this Balance Sheet the assets appear at their true value—\$890,000. Some might prefer to carry the buildings at \$80,000 with an offsetting account of \$10,000 on the liabilities side, under the name of Allowance for Depre-

Other So-Called Reserves

It is not possible to enumerate all of the so-called reserves, but usual ones are—

- Reserve for Unpaid Wages,
- Reserve for Taxes (unpaid),
- Reserve for Accrued Interest.
- Reserve for Salaries,
- Reserve for Depletion,
- Reserve for Depreciation.

The first four of the above are liability reserves and should be accorded the same status as Accounts Payable. They are, in effect, so far as invested capital is concerned, at least, the equivalent of borrowed money. The last two are Valuation Accounts, sometimes called Negative, or, Suspended-Credit Reserves.

None of these, nor any similar item can be included in invested capital, except Reserve for Federal Taxes, and this Reserve can be included only up to the date or dates that the taxes become due and payable.

If all of such "reserves" were termed "allowances," as they should be, one's mind would be less hazy and bewildered on the subject of what should be included in, or excluded from, invested capital. But since bookkeepers seem disposed to designate many a thing a "reserve" for lack of knowing a better name, we must accept things as they are and deal with them accordingly. It is not the writer's part, here, at least, to educate the bookkeepers of the country in the better way.

Some might insist upon calling the first four given above "accruals." It is true that they do represent accrued liabilities, but it also is true that when any such an account

is set up, it represents an amount allowed to take care of the liability, and, therefore, may very properly be termed an allowance; but observe that the moment the liability is paid, some asset is reduced by an equal amount, while in the event of the extinguishment of a true reserve, the amount of assets remains unchanged.

One Intelligible Sign-Board

There is at least one sure thing upon which you can depend when considering whether or not any given reserve should be included in invested capital, and that is this:

- (a) If the account represents a determined, or determinable, liability, as at the last day of the preceding accounting period, then it constitutes no part of Surplus; neither is it invested capital; it is only the equivalent of borrowed money—and borrowed money in any form can not be regarded as a part of, or as an addition to, invested capital. See Article 812.
- (b) If the account represents depreciation, depletion, or any wasting away or reduction of value designated by a more or less analogous term, it forms no part of invested capital. As before stated, such accounts are sometimes classified as Negative Reserves, or Suspended-Credit Reserves.

There is a possible exception to the statement that none of the above reserves (so-called) may be included in invested capital. If the officers of a corporation decide to leave their salaries in the business, but are to be paid interest on the money, and if their claim for payment of the amounts left in the business would take priority to, or be on an equality with, other creditors, then a Reserve set up covering the amount of the money left in the business by the officers can constitute no part of invested capital.

If, however, the officers' claim for payment would not take precedence over other creditors, or be on a par with the general creditors, then such a Reserve could properly be made a part of invested capital. Study Article 813 very carefully. Also, Article 814.

An Exceptional Treatment

Some financial institutions, such as banks and insurance companies, use the term "reserve" in a manner altogether different from the common practice of commercial bookkeepers and public accountants, in that the term is found on the asset side of their balance sheets. As used by them, the term has no connection whatever with surplus, profits, or, in fact, with any specific item. What it actually does mean in such balance sheets is cash, or the equivalent of cash in liquid assets.

An Exceptional Reserve

There is one reserve, which, technically speaking, is not a true reserve, that may be included in invested capital. This is the account, Reserve for Bad Debts. It may, conceivably, be a true reserve, and it may not. It may be a Negative, or Suspended-Credit Reserve. All of the Accounts Receivable and (or) Notes Receivable may be collectible, or collected, but the probabilities are that some of them will prove to be worthless, or partly so. But for income and profits tax purposes, the fact that the Reserve is, doubtless, a Valuation Account, is ignored and it is included in invested capital, unless, of course, the Reserve covers accounts or claims that should have been written off the books during a previous or previous periods.

Another Guide Post

Another test as to whether or not a reserve, real or so-called, should be included in invested capital: If the

account is of such a nature that the corporation may rightfully deduct the amount from gross income in arriving at the amount of net taxable income, then it can not be included in invested capital. A law of physics tells us that no one thing can be in two places at the same moment. This law can be made to apply here in this way—an account can not be placed among deductible items, and, at the same time, be included in invested capital. If it is a deductible item, it is not invested capital; if it is not a deductible item, then it is invested capital.

In the chapter on Depreciation, Depletion and Obsolescence, you will be advised as to the only exception to the application of this rule, which can happen only in the case of a corporation taking depreciation on the value of an asset as at March 1, 1913.

Contingent Reserves are Invested Capital

Any contingent reserve, that is, any reserve set up as an offset to something that may or may not transpire in the future, should be included in the computation of invested capital. The usual reserves of this class are—

Reserve for Improvements (possibly),

Reserve for Rebates,

Reserve for Guarantees,

Reserve for Discount,

Reserve for Accidents,

Reserve for Employees' Liability Insurance, Damaged Crops, and similar potentialities,

and, in addition, the general, all-embracing reserve, Reserve for Contingencies, which may include any or all of the above, as well as many others.

Specific Reserves

There is another class of reserves that deserve mention—the Specific Reserves—that should not be embraced under the classification of “Contingent Reserves,” although there are conditions under which some of them could properly be so classified. If a concern has definitely determined to extend its plant, a reserve set up for that purpose is not a contingency, but is an actuality. Such reserves as—

Reserve for Plant Extension,

Reserve for Bond Redemption,

Reserve for Amortization of Good Will,

Reserve for Improvements (possibly),

and all similar reserves are of this class and are a part of invested capital. In fact, any true reserve that is properly a direct charge to Surplus must be included in invested capital.

One other possibly contingent reserve will be found occasionally—Reserve for Redemption of Coupons. No positive dictum can be given on this. The author would, should he be auditing a case containing such a reserve, ascertain the past experience of the concern as to what percentage of such an account is an actual liability and would allow as invested capital the difference between the amount of the ascertained liability and the amount set up in the reserve. It is conceivable that analogous procedure should be followed in Reserve for Guarantees, such as we get with Hole-Proof Hosiery, or Reserve for Rebates, as where a rebate may be allowed each purchaser contingent on a lessening of selling price by reason of quantity production, as was done at least once by the Ford Motor Company. In any of such cases the auditor must exercise careful judgment and obtain all the data possible that apply to the case

and base his conclusions solely on the information bearing on the instant case and not on any generalities, for in cases involving possible contingent liabilities generalities can not be accepted as guides.

Fix firmly in your mind this fact: A true reserve is allocated Surplus and nothing else. At any time the board of directors may wipe out the Reserve and throw it back into Surplus, thereby making it available for dividends, or for any other purpose they may decide upon. The reason for setting up such a reserve is to "tag" a certain portion of Surplus for some definite object to the end that it may not be easily available for dividends, or to keep grasping stockholders from demanding larger dividends than are being declared; a scheme to "pull the wool over the stockholders' eyes."

Reserve for Insurance

Some concerns, having plants or buildings at different localities, carry their own fire insurance; that is, they set up a Reserve for Insurance, charging it to Surplus, and, in case of loss by fire charge the loss to the Reserve.

The status of this Reserve is as difficult to define as is the status of Reserve for Bad Debts, and it occupies a position very similar to the position of the latter in that it may be a true reserve, or a portion (and, perhaps, all) of it may be a Suspended-Credit Reserve. To the extent that it represents a true reserve (which can be determined only by an examination of the books of the corporation), it should be included in invested capital.

Funds

Hold fast to the fact that funds are assets, and that reserves are found on the other side of the Balance Sheet, frequently as contra entries to funds. Note the location of the various items on the—

BALANCE SHEET

<i>Assets</i>	<i>Liabilities and Capital</i>
Funds	Reserves
Sinking Fund	Allowances
Reserve Funds	Funded Reserves

If you have been studying any books on accounting that place any of the above on the side of the balance sheet the reverse from what is here given, do not continue to be misled. The above distribution of these accounts is absolutely correct, and the only correct distribution, eminent authors to the contrary, notwithstanding. Dicksee, in his work, "Good Will and Its Treatment in Accounts," presents (on page 129, third edition) Reserve Fund as a liability item on the balance sheet. It should be interesting to know if he would place the contra account, Funded Reserve, among the assets!

Double Use of the Term "Sinking Fund"

It should be noted that some concerns, especially transportation lines, occasionally carry Sinking Fund both as an asset and as a liability, as—

<i>Assets</i>	<i>Liabilities and Capital</i>
Cost of Construction. \$59,400,000	Capital Stock. \$30,000,000
Cash in Hand of Sinking Fund Trustee.. 300,000	Funded Debt. 30,000,000
Cash 900,000	Sinking Fund. 300,000
	Balance of Income Account 300,000
<hr/>	<hr/>
\$60,600,000	\$60,600,000
<hr/>	<hr/>

This is unusual treatment. If the word "reserve" fol-

lowed "sinking fund" on the liabilities side, the apparent contrariety would disappear, and the Balance Sheet would fairly indicate, as it should, that the amount, \$300,000, is Appropriated Surplus and that it should be included in the computation of invested capital.

Balance Sheet Examples of the Use of Terms

The following illustrations of the different ways of indicating values, and Surplus and Reserves, will impress on your mind the fact that calling "cash" by other names does not affect its status. For pedagogical reasons no attention is paid to arranging the items in true technical sequence.

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$300,000	Notes Payable.....	\$100,000
Accounts Receivable....	150,000	Capital Stock.....	500,000
Sundry Assets.....	450,000	Surplus	300,000
	<u>\$900,000</u>		<u>\$900,000</u>

No statutory adjustments entering into this proposition, the invested capital is \$800,000; that is, Capital Stock plus Surplus. See Article 831.

Now let us assume that instead of Notes Payable, the corporation had issued bonds to the amount of \$100,000 in January, 1917, payable in ten years, and that it was stipulated (as is usual) in the contract with the purchaser of the bonds that out of the profits of each of the ten subsequent years, there was to be placed in the hands of a trustee \$10,000 as a Reserve Fund (disregarding, for the moment, the compounding of interest) to take care of the bonds at maturity. This fund might be called simply

Fund, or it might be called Reserve Fund, Sinking Fund, Bond Redemption Fund, or by any other name that should indicate its function. At January 1, 1918, the Balance Sheet might appear as follows:

<i>Assets</i>	<i>Liabilities and Capital</i>
Cash .....\$290,000	First Mortgage Bonds...\$100,000
Reserve Fund..... 10,000	Capital Stock..... 500,000
Accounts Receivable.... 150,000	Surplus 300,000
Sundry Assets..... 450,000	
<hr/> \$900,000 <hr/>	<hr/> \$900,000 <hr/>

The invested capital is still \$800,000. You will see by this that a reserve fund does not affect invested capital—it simply changes the account, Cash, into two accounts; Cash Account, and Reserve Fund Account. Of course, you know that Funds mean Money and that Money Means Cash; hence, Funds usually mean Cash. For that matter, the word “cash” need not appear on a balance sheet. “Funds” is equally appropriated.

It might be, although it would be, perhaps, unusual, that the Fund would be created out of some liquid asset other than Cash, as, for instance, out of Securities. In such an event, Securities Account would be the account that would be divided into two accounts (provided the concern held more securities than the amount of the Fund) instead of Cash Account.

Now assume that the corporation contemplates the erection of a building (or some other improvement, as the purchase at a future date of new machinery, additions to present buildings, the installation of a sprinkler system, or, etc.). It is felt that it would be wise to make certain that too much will not be declared out as dividends and

it is decided to set up a reserve for this purpose. The Balance Sheet might then appear as follows:

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$290,000	First Mortgage Bonds..	\$100,000
Reserve Fund.....	10,000	Capital Stock.....	500,000
Accounts Receivable....	150,000	Reserve for Building...	100,000
Sundry Assets.....	450,000	Surplus	200,000
	<u>\$900,000</u>		<u>\$900,000</u>

The amount of invested capital has not changed; it is still \$800,000. At any day the Directors may decide not to build and may vote to restore the Reserve to Surplus—it IS Surplus under another name, just the same as Funds is Cash under another name. But, even though the corporation goes ahead and erects the building, invested capital is not affected. The Balance Sheet, after the building is built, might appear as follows:

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$190,000	First Mortgage Bonds...	\$100,000
Reserve Fund.....	10,000	Capital Stock.....	500,000
Accounts Receivable....	150,000	Surplus	300,000
Building	100,000		
Sundry Assets.....	450,000		
	<u>\$900,000</u>		<u>\$900,000</u>

The following journal entries would probably have been made to bring about the status of the accounts as reflected on the above Balance Sheet:

Building	\$100,000
Cash	\$100,000
(Explanation)	
Reserve for Building.....	\$100,000
Surplus	\$100,000
(Explanation)	

No change has taken place in the amount of invested capital; it is still \$800,000.

These problems, it should be noted, are stated as though all these transactions took place simultaneously. Of course, if another year has gone by, the Reserve Fund in the above Balance Sheet should be \$20,000, instead of \$10,000, and Cash would be \$10,000 less, but that makes no difference in values, or in invested capital.

One of the most difficult reserves properly to classify, is Reserve for Bad Debts. As previously noted, it may be a true reserve and it may not. Had the above-mentioned corporation set up a Reserve for Bad Debts, the Balance Sheet might appear thus:

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$190,000	First Mortgage Bonds..	\$190,000
Reserve Fund.....	10,000	Reserve for Bad Debts..	15,000
Accounts Receivable.....	150,000	Capital Stock.....	500,000
Building	100,000	Surplus	285,000
Sundry Assets.....	450,000		
	<u>\$900,000</u>		<u>\$900,000</u>

It could quite properly be set up as shown below, which will make it clear to you that this Reserve, so far as profits taxes are concerned, has the precise status of Surplus:

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$190,000	First Mortgage Bonds..	\$100,000
Reserve Fund.....	10,000	Capital Stock.....	500,000
Accounts Receivable....	150,000	Surplus:	
Building	100,000	Reserved (for Bad	
Sundry Assets.....	450,000	Debts)	15,000
		Unreserved	285,000
	<u>\$900,000</u>		<u>\$900,000</u>

Funded Reserves

Suppose that this corporation wishes to be certain of having \$75,000 available cash on hand at some time in the indefinite future, or at a definite future date. The account, Cash, already has been divided into two accounts—Cash Account, and Reserve Fund Account. It now further subdivides Cash and sets up a Special Reserve Fund Account. It also wishes to guard against declaring too large a dividend, or it does not wish the stockholders to know just how much could be available for dividends. Surplus can be further sub-divided by setting up a Funded Reserve, as shown by the following Balance Sheet:

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$115,000	First Mortgage Bonds...	\$100,000
Reserve Fund.....	10,000	Reserve for Bad Debts..	15,000
Special Reserve Fund...	75,000	Funded Reserve.....	75,000
Accounts Receivable....	150,000	Capital Stock.....	500,000
Building	100,000	Surplus	210,000
Sundry Assets.....	450,000		
	<u>\$900,000</u>		<u>\$900,000</u>

Still the invested capital is \$800,000. It should be

clear from a study of this Balance Sheet that the term "Funded Reserve" means that funds have been set aside to the amount of the Reserve, and that is all that it does mean; the Reserve is funded.

This Reserve might have been allowed to remain in Surplus, since there is no direct accounting relationship between any specific item on the asset side with any specific item on the liability side. Either can be set up without any necessity (from the viewpoint of accountancy) for setting up the other, and either may be eliminated without the necessity (technically speaking) of treating the other in a like manner.

To make the matter still clearer, Cash *could* be made to appear in the above Balance Sheet in this manner:

<i>Assets</i>	
Cash:	
Checking Account.....	\$115,000
With Trustee.....	10,000
Special Fund.....	75,000
	<hr/>
	\$200,000

The objection to this way of stating "cash" is that it requires scheduling a "current asset" with other classifications of assets. The technician will tell you that to set up Cash on a Balance Sheet in this manner is indefensible, and he would be stating a fact. The only reason for so doing in this case is to impress on your mind that to transform the account Cash, into other asset accounts, does not affect values in the least.

In the preceding illustrations you have been shown certain reserves that are to be included in invested capital, and you have been told why they are to be included. The

problem that follows illustrates cases where certain reserves (so-called) may not be included in the determination of invested capital.

We shall assume that the building for which a reserve had been created, was erected in January, 1914, and that its probable life at that time was fifty years. In December, 1917, the corporation had a crew of men engaged in Civil Engineering at a remote point, and at December 31, 1917, the report of the foreman covering certain expenses connected therewith had not been received. The following is the—

BALANCE SHEET

as at December 31, 1917

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$115,000	First Mortgage Bonds.	\$100,000
Reserve Fund.....	10,000	Reserve for Bad Debts.	15,000*
Special Reserve Fund...	75,000	Reserve for Surveying	
Accounts Receivable....	150,000	Expenses	9,000
Building	100,000	Reserve for Deprecia-	
Land	80,000	tion	6,000
Sundry Assets.....	400,000	Capital Stock	500,000*
		Surplus	300,000*
	<u>\$930,000</u>		<u>\$930,000</u>

At first glance one would say that the invested capital is \$815,000, made up of the items marked with the asterisk. A closer inspection discloses the fact that, while the land is now actually worth \$80,000, the cost price was \$50,000. We find that the building was erected in January, 1914, and that it should be depreciated for four years, at 2% per annum. Also, we find that Sundry Assets, while they

Secret or Hidden Reserves

At the present time, when corporations are striving to show as large an invested capital as possible, we are not likely to be much troubled with secret reserves, deliberately created by a corporation.

However, many a corporation creates, in effect, a secret reserve unconsciously. Where too much depreciation is charged off, or where capital expenditures are charged to Expense, hidden reserves are created.

In the matter of the Z-Y Corporation it was found that it had depreciated its plant by \$165,000, whereas the actual depreciation was only \$92,000. Also, it had charged to Expense, not only the engineer's plans and specifications for the location of some new machines in its plant, but the machines had been charged to Expense. The total thus charged to expense was \$8,350, consequently the assets were understated by \$81,350, which is equivalent to a secret or hidden reserve, and should be reflected in Surplus, thereby increasing the invested capital of the concern, and, of course, increasing the taxable net income of previous periods by a like amount.

Allowance for Doubtful Accounts Must Be Included

Occasionally you will find a Balance Sheet set up similar to the following:

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$100,000	Notes Payable	\$80,000
Accounts Receivable	\$20,000	Capital Stock.....	200,000
Less 2% for Doubtful Accounts	400 19,600	Surplus	139,600
Sundry Assets.....	300,000		
	<u>\$419,600</u>		<u>\$419,600</u>

A hasty glance at the above would indicate that the invested capital should be \$339,600. This is not correct. It should be plain to you that had Accounts Receivable been set up on the Balance Sheet at the total of \$20,000 and an Allowance for Doubtful Accounts, amounting to \$400, shown on the liabilities side, it would then be evident that the invested capital would be, Capital Stock, \$200,000; plus Allowance for Doubtful Accounts, \$400; plus Surplus, \$139,600, giving a total invested capital amounting to \$340,000, for, as you were previously told, the Allowance for Doubtful Accounts is included in invested capital, and if it should appear set up as above, the Allowance amount deducted from the total of Receivables must be added to Surplus in computing invested capital.

An Anomaly

Why have an account termed either "Reserve for Bad Debts" (all will agree that this expression is quite common) or "Allowance for Bad Debts?" If the debt is "bad"—worthless—it should be charged off, and there would be no call for any such account. The only truly descriptive title is "Allowance for Doubtful Accounts." A doubtful account may be collected; a "bad" account never is.

It may be asked why I do not, in all cases, adhere to the terms recommended. Simply this: It is wished to present to you balance sheets such as are found in taxpayers' returns to show you the work as it is presented to us; not as we would have it appear.

Things to Remember

Every item on the asset side must first be adjusted to its true value based on its original cost, less any depreciation since the time of its acquisition, and that every time any such adjustment is made, a like adjustment must be made to Surplus.

Appreciation of values, no matter how real or actual it may be, is not admitted in computing invested capital.

The reserves that may be included in invested capital are the Specific Reserves and reserves that have been set up to offset future contingencies. No other reserve may be included in invested capital.

If there is an account, Undivided Profits, it must be examined just as closely as the Surplus Account. If such an account is on the Balance Sheet, and sufficient depreciation has not been charged to Profit and Loss or if earnings (so-called) are the result of enhanced values, and these earnings have been entered as a credit to Undivided Profits (or to Surplus), Undivided Profits (or Surplus) must be reduced by the amount of inflation. Study Articles 162, 164, 165, and 169.

CHAPTER NINE

TANGIBLE PROPERTY—INTANGIBLE PROPERTY

All corporate property must be classed either as tangible property or as intangible property.

The income tax definition of these two terms is not in complete harmony with the Websterian definition, in that Webster defines "tangible" as, "capable of being touched, possessed, etc.," and, of course, "intangible" is defined as being the exact opposite of "tangible."

All intangible property is "capable of being possessed," and some tangible property is not "capable of being touched." Certain it is that a patent or a copyright is just as "tangible" as are accounts and notes receivable, in so far as the dictionary definition applies.

It seems to the author that the adoption of the terms "tangible" and "intangible" was unfortunate—the result often being mental confusion on the part of the auditor. If the terms "tangible-value property" and "intangible-value property" had been adopted the matter would have appeared much clearer in the mind of the average auditor, for those terms precisely express what is meant. We can "see" the value in a ton of steel rails, or in a carload of coal, but the value of a copyright or of a trade-mark is not so evident.

That the terms just named are really appropriate is proved by the fact that any of the properties classified by law and regulations as intangible lose their tangible aspect the moment they are acquired by a corporation for cash

or in any manner other than by the issuance of stock or shares of the acquiring corporation; in other words, the value in such cases can be "seen" and such property, for invested capital purposes has become tangible, although the property itself is just as intangible as it was previously.

Since it is easier to specify the kinds of property that are classified as intangible than it is to name the various properties that are classified as tangible, there is given below a list of the chief intangibles:

Patents,	Goodwill,
Copyrights,	Secret Formulae,
Trade-Marks,	Most Contracts,
Trade Names,	Mailing Lists,
Trade-Brands,	Subscription Lists.
Associated and United Press and similar Franchises.	

All property that is not intangible must be regarded as tangible. See Article 811.

Reason for the Distinction

Usually, tangible property is of such a nature that a definite, fair cash value can be placed upon it. It is not at all difficult to ascertain the value of, let us say, a thousand tons of pig iron, or of a parcel of real estate, or of a building, or of a piece of machinery.

If a corporation acquires any property of this class (the tangible class) and pays for it with stock or shares of the corporation, we can readily determine whether or not it gave stock in excess, on the basis of the par value of the stock, of the actual cash value of the property acquired.

Practically all items of merchandise, machinery of every description, transportation equipment, live stock,

minerals, timber, etc., have a known or ascertainable market value. If the market value of real estate can not be determined, the fair value can be arrived at in other ways, as, for examples, sales in the immediate vicinity, bona fide cash offers recently made (with reference to the date of acquisition) for the property or for adjoining property, recourse to the city or county assessment books, or by reputable appraisal.

Observe, however, that none of these methods should be resorted to in order to determine the value of property for invested capital purposes where it has been bought for cash, or for the equivalent of cash. We have reference only to the ascertainment of value (or worth) where any tangible property has been taken in exchange for stock or shares and where the stock or shares have no well-determined value. When any property is purchased for cash, the amount of the cash paid sets the value, for invested capital purposes, and not what may be determined or thought to be the value of the property.

In this connection, "cash" may mean things other than money. Other property, if tangible, would be an equivalent of cash. Also, notes, or other instruments of indebtedness given for the property, in good faith, would be regarded as the equivalent of cash.

No Market Quotations on Intangibles

On the other hand, where can we find a market quotation on the value of goodwill? or on a copyright? or on a patent? There are no such standards upon which to base conclusions.

The amount that the goodwill of Brown, Davis & Co., sold for has no bearing whatever on the value of the goodwill of Smith, Jones & Co. That some patent earned a million dollars for its owner has no bearing in arriving

at the value of any other patent, even of a patent on something very similar, and, perhaps, greatly improved.

The fact that the name "Kodak" may be valuable as a trade name does not indicate that any other trade name, or trade-mark, would possess any value. In fact, the value placed upon any intangible property, whether paid for in cash or in stock, is only a guess at best, based (usually) on the income that the intangible may have possibly earned in the past, and the hope that it will continue to be equally productive of profit in the future.

If Jones buys a carload of wheat and pays \$3 a bushel for it, and \$3 is its market value, then that is the value of Brown's or of Smith's wheat, due to the fact that their wheat will produce practically the same amount of flour as may be obtained from Jones' wheat—it possesses precisely the same economic value.

That the copyrights to Longfellow's poems were extremely valuable to their owners does not set any value on a copyright on "Poems by Shortfellow." There is no analogy between the method of arriving at the value of Brown's wheat and the value of Shortfellow's copyright. We know just what the wheat will produce; we do not know that the copyright will earn even the dollar that it cost to procure it.

Now if Shortfellow sells his copyright to Cohn for \$10,000 cash, the sale establishes Cohn's invested capital in the copyright at \$10,000, the presumption being that he would not part with that amount of cash in exchange for the copyright unless he could see, or thought he could see, that value in it. Whether or not that value is there is not open to question; he was willing to part with \$10,000 for it, hence his invested capital in this intangible is the amount he put in it—it now is tangible-value property to the extent of \$10,000.

Shortfellow, being so successful with this copyright on his authorship, gets out another book, "The Joys and Pleasures of a Revenue Agent," and, of course, another copyright. The fact that he received \$10,000 for the first copyright does not operate to set a value—big or little—on the second copyright. It may be worth nothing—it may be worth a million, but whether it be worth more or less is purely problematic. Of course, once an author scores a success, it is generally conceded that the public will wish to read his subsequent works, but that is only presumption and has no weight in so far as income tax is being determined.

If Brown gets \$3 for one bushel of his wheat, the other bushels in his granary or elevator are reasonably presumed to be worth \$3 each, because they will produce exactly the same results as did the first bushel. If a corporation issued \$30,000, par value, worth of stock for 10,000 bushels of Brown's wheat, and \$3 was the market value, we would admit that the stock brought par value to the corporation.

Now this gives us the key to the reason for valuing tangible property and intangible property upon entirely different bases. In the case of tangibles, the true value almost always is determined or capable of determination, while in the case of intangibles, any value placed upon them is only hypothetical at best—a pure guess, unless they be sold (or purchased) for cash—and that is another matter, to be told later.

When tangible property is acquired in exchange for stock or shares we can usually determine the actual value that the stock or shares contributed to the business. When intangible property is acquired for stock or shares we can allow only on a percentage basis the amount to be reflected in invested capital. The rate of percentage used is purely arbitrary, but, inasmuch as it is impossible to arrive at an exact, or even an approximate value, this is the only

feasible way out of the dilemma of placing a value, for invested capital purchases, on intangible property.

Tangible Property Paid in for Stock or Shares

Where tangible property has been paid in for stock or shares, it is valued at its actual cash value at the time it was acquired by the concern. If this value be less than the par value of the stock or shares issued therefor, the amount to be allowed as a basis of invested capital is the cash value of the property, and not the par value of the stock or shares issued for it.

Similarly, if the property, at the time it was paid in, had an actual cash value over and above the par value of the stock or shares issued therefor, the corporation may set up a Paid-in Surplus reflecting the difference between the par value of the stock or shares and the actual cash value of the tangible property for which the stock or shares were issued. See Article 836.

Intangible Property Paid in for Stock or Shares

Where intangible property has been paid in for stock or shares, the procedure relative to ascertaining the value thereof is much different from the course followed with respect to tangible property paid in for stock or shares.

No matter how much may be its presumptive actual cash value, the amount allowable as a basis for invested capital is rigidly established on a percentage basis thus—

Paid in Prior to March 3, 1917

If intangible property is paid in for stock or shares prior to March 3, 1917, the amount that may be included in invested capital must not exceed—

- (a) The actual cash value of the (intangible) property paid in. Assume that a corporation issued \$50,000, par value stock for good will (or other intangible). Upon investigation it is found that the actual cash value of the intangible at the time it was paid in, was \$60,000. The amount included in invested capital must not exceed \$60,000. Perhaps that much may not be allowable. This we shall determine as we proceed.
- (b) * * * must not exceed the par value of the stock or shares issued therefor.
It is therefore clear that we may not allow the \$60,000 cash value, for that would exceed the "par value of the stock or shares issued therefor."
- OR (c) * * * must not exceed, in the aggregate, 25 per centum of the total stock or shares of the corporation outstanding March 3, 1917, WHICHEVER [of the three restrictions] IS LOWEST.

Now, what have we?

Under (a) we find that the actual cash value is \$60,000

Under (b) we find the par value of the shares issued therefor to be..... \$50,000

We find the par value of the stock outstanding March 3, 1917, to be.....\$100,000

Under (c) we find that the amount to be allowed may not exceed 25 per centum of this amount of stock, or..... \$25,000

Therefore, the amount allowable is \$25,000, notwithstanding the value of the acquisition in excess of \$25,000, nor the excess of value of the stock over this amount.

Paid in Subsequent to March 3, 1917

Intangible property, bona fide paid in for stock or

shares on or after March 3, 1917, is allowable in an amount not exceeding—

- (a) The actual cash value of such property at the time paid in.
(Assume that we find that the cash value of a patent that was paid in for stock or shares was \$5,000.)
- (b) * * * not exceeding the par value of the stock or shares issued therefor.
(Assume that stock to the amount of \$30,000 was issued for the patent.)
- OR, (c) in the aggregate, 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year.

We find that at the beginning of the taxable year, January 1, 1919, the par value of the total stock outstanding was \$500,000, and 25 per cent of this amount is \$125,000. Shall we allow this amount on the patent? NO! The Act states that the allowable amount is determined by (a), (b), OR (c), WHICHEVER IS LOWEST. Inasmuch as the actual cash value is lowest, \$5,000 is the most that is allowable.

Caution

If, after March 3, 1917, the corporation cancelled, or bought in, or there was returned to it some of its stock, say in November, 1917, goodwill or other intangible acquired for stock or shares prior to March 3, 1917, should be computed for 1918 upon the basis of the amount of stock outstanding after the acquisition of its stock by the corporation, without regard to the amount of stock outstanding on March 3, 1917.

Further, if the corporation issued additional stock after March 3, 1917, the amount of intangibles allowed

(for which stock or shares was issued prior to March 3, 1917) should be based on the amount outstanding on March 3, 1917.

In other words, base the amount of intangibles upon the amount of stock outstanding on March 3, 1917, or on the amount outstanding at the beginning of the taxable year, whichever is lower, when arriving at the portion of the intangibles to be allowed and which was acquired prior to March 3, 1917, by the issuance of stock or shares of the corporation.

Goodwill having no value is seldom charged off. It will usually be found a corporation, which, owing to a desire to be conservative, charges off goodwill, is the concern that really has goodwill of value. Corporations whose goodwill is without value are, ordinarily, the ones that continue to carry it on their books.

An Erroneous Impression

Some auditors have the opinion that 25 per centum of the amount of stock outstanding must necessarily be allowed; in other words, they appear to think that the 25% limit is a *minimum* amount. Such is not the case. The 25% limit is the *maximum* amount that is allowable. If the intangible were found to be of no value at the time acquired (and often so-called goodwill is valueless) no amount can be allowed.

An Important Exception

Note that the Act states: "If stock or shares were issued for intangibles * * * ." Any intangible purchased with cash or the equivalent of cash, is allowable in an amount equal to the cash paid for it regardless of its value, provided, of course, that the transaction was a bona fide one and not a scheme to beat the government

or to fill the pockets of a favored stockholder or other person at the expense of the corporation.

Depreciation of Intangibles

This phase of intangible computation is covered in the chapter on Depreciation.

An excellent exposition of the treatment of certain kinds of depreciation is to be found in Cumulative Bulletin, December, 1919, beginning at the bottom of page 133. Also, Article 163, as revised, is quoted below, and should be studied, and if it appears differently in your copy of the Regulations, you should make the necessary notations on the margin of the Article in your copy.

Article 163. Depreciation of intangible property—"Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible assets may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner."

A Hypothetic Proposition

The Miggs Automotive Company, January 1, 1919, had stock outstanding in the amount of \$6,000,000, par value. An examination of the books of the corporation discloses the following intangibles and the manner in which they were acquired by the corporation:

March 12, 1917, patent, \$100,000, paid for with stock.

March 20, 1917, patent, \$30,000, purchased for cash.

June 12, 1917, patent, \$52,000, taken in payment of a note of equal amount. Note was considered good.

August 18, 1917, trade brand, \$25,000, taken in exchange for stock of the corporation.

September 2, 1917, copyright on an Auto Instruction Book, \$3,000. Paid for by giving a \$3,000 automobile in exchange for the copyright.

September 30, 1917, chemical formula for determining the carbon content of steel. Cash value was thought to be \$65,000. Paid in for stock, \$40,000; cash, \$30,000.

December 15, 1917, goodwill of the Consolidated Motor Company, \$500,000, paid in for stock. Conservative estimators regarded this as a low price.

December 15, 1917, mailing list of auto users, paid in for stock, \$200,000. List contains 1,560,000 names. Such lists are considered worth 20 cents per name.

December 20, 1917, formula for making a substitute for gasoline out of water and ethyl aldehyde. Price \$300,000, paid in for stock, \$275,000; cash, \$25,000. It proved to be an impractical idea.

In computing invested capital what value shall we place upon the above intangible properties?

First, let us tabulate the items, classifying them according to the nature of the compensation given for them:

	Stock	Cash	Other Property
Patent	\$100,000	.....	.....
Patent .....	.....	\$30,000	.....
Patent .....	.....	.....	\$52,000
Trade Brand.....	25,000	.....	.....
Copyright .....	.....	.....	3,000
Formula	40,000	30,000	.....
Goodwill	500,000	.....	.....
Mailing List.....	200,000	.....	.....
Formula	275,000	25,000	.....
	<hr/>	<hr/>	<hr/>
Totals.....	\$1,140,000	\$85,000	\$55,000
			85,000
			<hr/> 1,140,000
			<hr/>
Grand total of intangibles.....			<u><u>\$1,280,000</u></u>

Second, we must allow all the intangibles to the extent that they were acquired for cash, as follows:

Patent	\$30,000	
Part of formula.....	30,000	
Part of formula.....	25,000	\$85,000
	<hr/>	

Also, we must allow all that was paid for by giving tangible property in exchange, based on the cash value of the tangible property given for the intangibles.

Patent	\$52,000	
Copyright	3,000	55,000
	<hr/>	<hr/>

Amount to be allowed that is not subject to the percentage limitation.....\$140,000

Observe that Section 326, (4) and (5) is so qualified as to be applicable only in instances where "intangible prop-

erty bona fide (is) paid in for stock or shares * * *.”
Intangible property paid in for cash or other tangible property is allowable to the extent of the full value given for it.

But note, however, that if an intangible is paid for with another intangible, it amounts only to an exchange of intangibles, and the 25% limitation would operate just the same as in any other case of an intangible subject to the limitation.

But to get back to our proposition. Deducting the amount allowed above, \$140,000 from the grand total, leaves \$1,140,000, and we must determine how much of this amount is allowable.

At the beginning of the taxable year the amount of stock actually outstanding was \$6,000,000. Twenty-five per cent of this amount is \$1,500,000, or \$360,000 in excess of the amount that was paid in for stock or shares. Shall we allow this amount? No, for we have found that the formula purchased December 20, 1917, and for which stock was issued in the amount of \$275,000, was without value; therefore, we must disallow the \$275,000. Deducting \$275,000 from the balance of \$1,140,000 leaves \$865,000 allowable to be included in invested capital.

This adjustment would be made in line 1, Schedule G, and on the working papers there might appear a table of intangibles made up similar to the table presented on a previous page.

Under G1 (page 4 of Form 1120) we find “* * *
the amount by which (f) exceeds (b) or (c) * * *.”

- | | |
|--|-------------|
| (f) equals the value as carried on the books of the corporation; that is, \$1,280,000 less the amount paid for with cash or other tangible property, or..... | \$1,140,000 |
| (b) equals the cash value; that is, \$1,140,000 less the worthless formula..... | 865,000 |
-

Inasmuch as (b) does not exceed 25 per centum of (e) the amount to be deducted in line 1, Schedule G, is..... \$275,000

You will observe from a study of the above that the 25% limitation does not embrace, or include, the intangibles acquired and which were not paid for in stock or shares of the corporation. To illustrate further:

The Starr Company had stock outstanding as at January 1, 1919, amounting to \$400,000. July 10, 1918, it paid \$100,000 cash for a patent. On the same day it acquired the goodwill of the Moon Company for \$100,000 stock of the corporation. We will not question the value placed on the goodwill.

The Starr Company is entitled to inclusion in its invested capital the total amount of intangibles carried on its books; that is, 25% on \$400,000, for the goodwill, and, in addition, the patent intangible for which cash was paid. In other words, the payment of cash or other tangible property (at cash value) for an intangible, removes, in a sense, the intangible from the realm of intangibles—gives it the status of a tangible.

Development of Patents, Etc., by a Corporation

Many concerns employ a staff of inventors, experimenters and investigators to develop or improve machines or other things along certain lines.

Assuming that a corporation in this way becomes the owner of a very valuable patent, it will not be permitted the corporation to carry this patent as an asset, for invested capital purposes, in any amount greater than the amount it actually cost the corporation to produce or perfect the patent, in which cost may be included government fees, attorney fees, the cost of making patent and other drawings, stenographic help, etc.

Where the cost of developing patents has been charged to current expense since January 1, 1909, the amount so charged can not now be set up as an asset. Where such cost of development has been charged to Surplus, or otherwise disposed of in such a way as not to reduce the net taxable income of the corporation, any amount so written off may be restored in computing invested capital.

This feature of intangibles is pretty well covered in Article 843, and you should make a thorough study of it.

Mixture of Tangibles and Intangibles

The Gary Company bought out the partnership of Anderson Brothers, paying therefor \$200,000. Of this amount, \$125,000 was paid for in stock of the Gary Company and \$75,000 in bonds of the Company. In the deal the corporation assumed liabilities of Anderson Brothers amounting to \$25,000.

The following assets were acquired in the transaction:

Factory Building.....	\$60,000
Machinery	38,000
Goods in Process.....	55,000
Finished Goods.....	20,000
Patents	12,000
Goodwill	40,000
Total.....	<u><u>\$225,000</u></u>

Two questions arise here. (1) Did the corporation pay for the patents and the goodwill by issuing stock, or did it pay for the intangibles by giving bonds for them? Upon the answer to this question depends whether the 25% limitation shall or shall not apply. If the bonds paid for the intangibles, the 25% limitation does not obtain, for bonds are the equivalent of cash.

(2) Did the liabilities assumed, amounting to \$25,000 partly pay for the tangibles or for the intangibles? If becoming liable for the liabilities paid for the intangibles, the 25% limitation does not apply to the intangibles to the extent of \$25,000, for here, again, the corporation would be acquiring intangibles in exchange for that which is the equivalent of cash. The limitation, would, however, apply to the intangibles in excess of the \$25,000.

Right here is where Article 835 applies. Refer to it and make a careful study of it. Note that we must assume that the bonds paid for the tangible property, or for an amount of tangible property equal to the amount of the bonds, therefore, of the \$173,000 tangibles acquired, \$75,000 worth of them were taken in exchange for bonds of the corporation.

We find, also, that the \$25,000 debts assumed pay for tangibles, and that stock paid for the remainder of the tangibles and for all of the intangibles, hence the 25% limitation applies.

Assuming that the corporation had capital stock outstanding at the beginning of the taxable year, amounting to \$100,000, we can allow intangibles only to the amount of \$25,000 (25% of \$100,000) and the difference between this amount that is allowable and the total amount of intangibles carried, amounting to \$52,000, or \$27,000, must be deducted in line 1, Schedule G.

Let it be stated in another way: For this same prop-

erty there was issued, stock, \$35,000; bonds, \$150,000, and the liabilities assumed amounted to \$40,000.

The tangibles amount to \$173,000. The bonds given and the liabilities assumed amount to \$190,000. After paying for the tangibles, we have \$17,000 remaining to apply against intangibles. This amount of intangibles must be allowed, and, in addition, 25% on the \$100,000 stock outstanding at the beginning of the taxable year. Total intangibles, \$52,000; paid in for bonds, \$17,000; 25% allowance, \$25,000; total intangibles to be included in invested capital, \$42,000; amount to be deducted in line 1, Schedule G, \$10,000.

Note that the Regulations state: "at the beginning of the taxable year." If a corporation files its return on a fiscal year basis, intangible allowance should be computed on the basis of the amount of stock outstanding as at the first day of the corporation's fiscal year, and not on the amount that might have been outstanding at January 1.

A Different Proposition

In January, 1910, the Bond Company issued \$100,000 stock, par value, for a patent, and \$50,000 stock for a secret formula. On March 3, 1917, the outstanding capital stock was \$600,000. This would entitle the corporation to include in invested capital intangible assets amounting to \$150,000, provided, of course, that it produces evidence in support of the claim that the intangibles were worth that amount at the time they were paid in.

At January 1, 1919, the corporation had capital stock outstanding amounting to \$1,000,000. It buys, November 30, 1918, a trade-mark, conservatively said to be worth \$200,000, and for which there is issued stock of the corporation to the amount of \$250,000.

How much intangible assets shall we allow this corporation to include in its invested capital?

Shall we limit it to the original \$150,000 on the basis of the stock outstanding March 3, 1917? No!

Shall we limit it to \$200,000, the apparent value of the trade-mark acquired in November, 1918? No!

Shall we allow intangibles amounting to \$150,000 plus the \$200,000, or a total of \$350,000? Again, NO!

The Act, under Section 326, (5), states: "Provided, that in no case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the *beginning* of the taxable year."

Inasmuch as the total par value of the stock outstanding at the beginning of the taxable year amounted to \$1,000,000, we should allow intangibles to be included in invested capital to the amount of \$250,000.

Attempting the Impossible?

Section 326, (5), (a) states, "The actual cash value of such (intangible) property at the time paid in." It would appear that this statement could have been more appropriately worded, for by inference we are instructed to do that which is next to impossible, if not altogether impossible.

Unless the intangible was purchased for cash, or for the equivalent of cash (and even then actual value is not established) it is extremely doubtful if you will ever have occasion to audit a case where the "actual cash value at the time paid in" is possible of determination.

If stock or shares were issued for an intangible, you might determine that the intangible had no cash value; in other words, that it was worthless, or it might easily be apparent that the intangible had some value, and, at the same time, it would be utterly impossible to arrive at what the "actual cash value" was.

Unless it can be shown that the intangible has no value, it seems to be the custom to grant the 25% limit and not to attempt a hair-splitting act by trying to arrive at a dividing line between some—an indeterminate—value and the amount that is allowable within the other limitations.

Article 851 is intended as an aid in this direction, and it should be studied and re-studied. It appears, however, that instead of this article applying to the general run of cases it can, from the very nature of intangibles, and from lack of, or inability to obtain, any definite conditions as are therein outlined, be applicable only in very exceptional cases. See Bulletin 10-20-777—A.R.M. 34 for methods of determining the value of intangibles.

Goodwill and No-Par-Value Stock

The Johnson Machine Co. has outstanding, January 1, 1918, Common Stock, amounting to \$100,000, par value. Also, it issued in December, 1917, 1,000 shares of no-par-value stock. On what amount of stock shall we base the intangibles?

First, we will allow (assuming that the intangible has value) 25% on the \$100,000 Common Stock. Second, we must ascertain the value of the no-par-value stock as at the date or dates of issue by finding what amount of value, in dollars, was received for the stock. We will then allow 25% on this value.

Thus, in the above instance, it is found that the 1,000 shares sold for \$70 per share—total \$70,000. We will allow \$25,000 on the Common Stock plus 25% on the value of the no-par-value stock, or \$17,500, making a total of \$42,500 allowable. See April, 1920, Digest, bottom of page 168.

Proration of Intangibles

The question is often asked: Shall we ever prorate intangible assets acquired during the year or sold during the year? The Regulations do not cover the subject specifically but we may assume that under certain conditions there would be a proration of intangibles based on the requirement that the invested capital of a concern for a given period is the average invested capital for the period, not the amount of invested capital the concern had at the beginning or at the end of the period.

We shall make four assumptions. The writer wishes you to understand that the views expressed on this subject are not in any sense official views—they are his personal views and the views of some of his able friends whom he has consulted. He would suggest that you weigh this subject carefully and base your conclusion on your own judgment as determined by the actual facts found in the instant case.

(a) A Corporation has, let us say, \$400,000 capital stock outstanding at the beginning of the taxable year. It claims intangible assets amounting to \$140,000, all of which were acquired by the issuance of stock or shares. Of this amount we would disallow \$40,000 on the principle that the amount of intangibles allowed shall not exceed 25 per centum of the capital stock outstanding at the beginning of the taxable year. During the year it is assumed that the concern issued additional stock for cash or property or other intangibles. Shall we allow the additional amount of intangibles? The answer is "no." We have already allowed the limit permissible under the law.

(b) Take the same corporation, having \$400,000 capital stock outstanding at the beginning of the taxable period. It claims intangibles to the amount of \$75,000, which were acquired for stock or shares. During the year it issued additional stock for \$100,000 more intangibles.

Shall we allow any in addition to the \$75,000 already allowed? The writer believes that we should allow the amount which, prorated, would be equal to, but not in excess of 25 per centum of the capital stock outstanding at the beginning of the taxable year. In no instance does the law or the regulations specify that the intangibles allowed must have been held at the beginning of the taxable period.

(c) Again assume a corporation with \$400,000 capital stock outstanding at the beginning of the taxable period. The corporation claims intangibles to the amount of \$200,000, all of which were acquired by the issuance of stock or shares. Under the law we will disallow \$100,000 of this amount and will allow \$100,000. Now we will assume that the \$200,000 intangibles is made up of four different patents. We will concede that all of these patents are valuable. During the year the concern sells one of the patents for \$50,000 in cash or the equivalent of cash. The question is: Does this affect invested capital? The writer believes that we should add \$50,000 to the invested capital prorated as at the date of sale. He assumes, of course, that the element of profit does not enter into this transaction—that the \$50,000 received for the patent was the value of the stock issued therefor.

(d) Let us carry assumption (c) a little further. This corporation sells all of the intangibles for \$200,000 cash or the equivalent of cash December 2 during the taxable year. It is assumed that the \$200,000 contains no element of profit. How shall this be treated? The writer would allow intangibles based on 25 per centum of the capital stock outstanding at the beginning of the taxable year multiplied by $335/365$ of a year and he would allow the \$200,000 to be brought into invested capital multiplied by $30/365$ of a year.

Things to Remember

Intangibles paid for with cash or its equivalent are allowable without limitation.

Intangibles acquired in any other way are subject to the limitations specified under Section 326.

There is a maximum amount that can be allowed when paid in for stock or shares of the corporation. There is *no minimum limitation*.

That the limitation is based on the amount of capital stock outstanding at the beginning of the taxable year. This means that if a corporation issues stock during the taxable year that additional stock can not be included in arriving at the amount of intangibles allowable.

It should be noted that items of experimental expenses, as the development of patents, the protection of copyrights and like items that have, since January 1, 1909, been charged to expense, can not now be restored to invested capital. It would seem, however, that such items of expense created prior to January 1, 1909, may be restored to invested capital, provided, it can be shown that such items were in reality, proper capital expenditures. Carefully re-study Article 843.

Observe that Goodwill placed on the books with a corresponding credit to Surplus, for which nothing was paid (either cash, property, or stock or shares) has no standing whatever. It has, in effect, the status of appreciation of values so far as invested capital is concerned and whatever the amount may be it must be disallowed; it is not even given the benefit of the 25% limitation.

CHAPTER TEN

ADMISSIBLES AND INADMISSIBLES

In the chapter on tangible property and intangible property you were told that all assets must be included in one or the other of these classifications. And so it is in the present case—all assets must be classified either as admissibles, or as inadmissibles. There is no middle-of-the-road class. Any asset that is not an inadmissible asset is an admissible asset.

Chapter Nine was wholly devoted to the methods of ascertaining the value at which certain assets may be *included in* invested capital. The aim of this chapter is to teach you how to determine, not the value of the asset, but rather the proportionate amount of certain assets that must be *excluded from* invested capital.

There is but little connection between the classifications described in Chapter Nine and the classifications described in the present chapter. Tangible property may be admissible, or it may be inadmissible. Intangible property can not be inadmissible.

What Is an Inadmissible Asset?

When we say that an asset is "inadmissible" it is not intended to convey the impression that it is to be excluded from the Balance Sheet. All inadmissibles properly belong in the concern's assets to the full amount of their cost; in other words, they are not subject to a percentage limitation as are intangibles.

What is meant by the use of the term "inadmissible" is that any such asset is not to be reflected in the final invested-capital-surplus, except under specific conditions and to a certain extent as will be fully explained as we proceed.

All admissible assets other than intangibles must be reflected on the liabilities side of the balance sheet at their cost less depreciation and depletion, if any. Intangible assets are admissible assets to the full amount of their cost (less depreciation, etc., if any) except when acquired by the issuance of stock or shares, when the amount at which they may be reflected in invested capital must be reduced as explained in Chapter Nine. However, the reduction of the amount does not cause the intangibles to become inadmissible. They must be classed as admissible assets.

An inadmissible asset is an obligation carried by a corporation, the dividends or interest from which are not subject to excess or war profits taxes. Article 815.

Note that "dividends" or "interest" is specified. The profit that may be derived from the sale of an inadmissible is not a dividend; neither is it interest. The profit derived from the sale of an inadmissible is subject to income and excess profits taxes to the same degree that any profit that is the result of the regular operations of the business is taxable.

What ARE the Inadmissibles?

The inadmissibles are few in number, but important. In the chapter on tangibles and intangibles it was said that it were easier to name the intangibles than to specify the tangibles. This is equally true in the present instance—it is easier to name the inadmissibles than it is to name the admissibles. The chief (perhaps all) inadmissibles are:

- Stocks of other domestic corporations,
- Stocks of foreign corporations deriving income from sources within the United States,
- Bonds of Porto Rico,
- Bonds of the War Finance Corporation, to the amount of \$5,000 (any amount held in excess of \$5,000 is admissible),
- Federal Farm Loan Bonds,
- Federal Reserve Bank Stock,
- Bonds of a Territory, State, County, Township, City, Borough, or other political sub-division of a state (or territory),
- District of Columbia obligations, or obligations of any other possession of the United States. See Article 816.

Confusion Sometimes Created Where None Should Exist

Perhaps you have heard that confusing play on words—an intangible inadmissible, or, an inadmissible intangible. Sounds formidable, does it not? Do not permit it to bother you. There is no such thing. A very good authority endeavored to convince the writer that such a thing could be, but he afterward admitted that he was mistaken. All intangible assets (note that we specify *assets*, which means things of worth) are admissible assets. They may come within the 25% limitation but they are admissible, nevertheless. The amount in excess of 25%, that is disallowed, is not to be regarded as an asset, and, not being an asset, it can be neither an admissible nor an inadmissible asset.

Computation Not Difficult

Many appear to think that to arrive at an understand-

ing of the correct treatment of inadmissibles is a difficult mental process. This is an erroneous impression. It is just as easy and simple to calculate the adjustment necessary in respect of inadmissibles as it is to adjust invested capital on the basis of the income and profits taxes that are payable at a given date, by pro-rating the amount over the period, and in this respect (the pro-ration) the procedure necessary to adjust for inadmissibles is exactly the same (provided, of course, that the amount held changes during the taxable year; otherwise, there is no pro-ration).

A great trouble with most of us is, "scattered vision." When we take up a balance sheet having inadmissibles to consider and other items to adjust, we are apt to look at the work involved in the aggregate. That attitude always causes more or less confusion. The best way is to take up each item by itself, entirely independent of any other adjustment that may have to be made—go about it just as one would if there were no other adjustments to be made. No one balance sheet adjustment is difficult. It is only when we mentally collate them and contemplate the total work apparent that the task seems difficult. Think of but one adjustment at a time. Decide just how it should be treated and then adjust IT. When the first one is done, take up the next one in the same way, and continue thus until the adjustments are completed.

A good plan to follow is to make up a new balance sheet, placing each asset at an amount that represents its cost at the time of acquirement less any valuation reserves that may or should apply thereto (except Reserve—or Allowance—for Doubtful Accounts). In making up such a balance sheet evaluate only one item at a time. If you will make certain to get the *present one* right, your invested capital is bound to be correct. It may be well to illustrate this method now. We will take the following untechnical balance sheet presumably furnished by a taxpayer and adjust the items to their invested capital values—

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$1,000	Capital Stock.....	\$80,000
Accounts Receivable	\$12,000	Surplus	97,000
Less: Allowance for Bad Debts..	1,000	Undivided Profits.....	8,000
	11,000	Notes Payable.....	10,000
Patents	15,000	Reserve for Depreciation.	2,000
Inventory	36,000	Reserve for Improvements	10,000
Buildings	20,000	Reserve for Machinery...	5,000
Land	15,000	Reserve for Patent Development	5,000
R. R. Bonds.....	5,000	Reserve for Unpaid Dividends	1,000
R. R. Stock*.....	5,000		
Pa. State Bonds*.....	5,000		
Chicago City Bonds*.....	5,000		
Treasury Stock.....	20,000		
Goodwill	80,000		
	<u>\$218,000</u>		<u>\$218,000</u>

Upon investigation we find the following to be the facts:

Amount of Cash, \$1,000 is correct.

Accounts Receivable account is correct, but we do not allow the allowance of \$1,000 as a deduction from gross income, hence, since every such item must either be allowed as a deduction or it must be reflected in surplus, we will have to allow the face value of the accounts—\$12,000.

We find that the patents cost, in cash at time of acquirement, \$5,000 and that development expenses amounting to \$3,000 have been capitalized. The patents are found to be valuable and the price at which they are carried is very reasonable. But all we can allow is cost—\$8,000.

The stock in trade inventoried \$40,000 at cost but the concern, fearing declines in prices, wrote off 10%. We must allow the full \$40,000.

We find that the buildings cost \$20,000 six years ago and that their probable life is twenty years. It is evident that they are being carried at an inflated amount; that they should be carried at \$14,000.

The land cost \$15,000, hence that is the invested capital sum.

We will pass by the three inadmissible items marked with stars (*) except that we have ascertained that the amounts at which they are carried, as well as the \$5,000 of R. R. bonds (which is an admissible asset) are the actual cost figures.

We have learned that Treasury Stock is not an asset—that it is a valuation account.

We find that \$40,000 of the Goodwill was acquired by the issuance of stock back in 1914, and that included in the \$80,000 amount was the purchase, for \$20,000 cash, the sole right to sell certain goods in a certain section. Since then the business has been very prosperous and the Goodwill is worth much more than \$80,000. How much of Goodwill shall we allow? The amount of stock outstanding has not changed since the acquirement by purchase at par, of the treasury stock. We can allow the \$20,000 cash-purchase amount at full cost. We can also allow 25% of the par value of the stock outstanding at the beginning of the taxable year, or $(\$80,000 - \$20,000) \times 25\% = \$15,000$. This amount, plus \$20,000 equals \$35,000 to be allowed in the place of the \$80,000 carried on the books.

Now let us set up our adjusted balance sheet. In so doing, we need only three items on the liabilities side—Capital Stock, Creditor Liabilities and Surplus.

Adjusted Balance Sheet

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$1,000	Capital Stock...	\$80,000
Accounts Receivable.....	12,000	Less Treasury	
Patents	8,000	Stock	20,000 \$60,000
Inventory	40,000		
Buildings	14,000	Debts	11,000
Land	15,000	Surplus	74,000
R. R. Bonds.....	5,000		
R. R. Stock.....	5,000		
Pa. State Bonds.....	5,000		
Chicago City Bonds.....	5,000		
Goodwill	35,000		
	<u>\$145,000</u>		<u>\$145,000</u>

If none of the above assets were inadmissible, we would now have the amount of this concern's invested capital; Capital Stock, \$60,000 plus Surplus, \$74,000; total, \$134,000. Before we can arrive at the true statutory invested capital we have one more adjustment to make—an adjustment on account of the inadmissibles carried—and as to just how that is done in every conceivable case is what the author hopes to demonstrate to you in this chapter.

Remember this: The adjustment to be made by reason of inadmissibles carried is the LAST adjustment to be made in computing invested capital.

Why Divided Into These Two Classes

The reason for making a distinction between the assets that are called admissibles and the assets that are called inadmissibles is that a concern that carries inadmissibles is allowed less invested capital than it would be allowed if all of its assets were admissible assets.

The amount of profits taxes depends, in large measure, on the amount of the invested capital. Inasmuch as inadmissibles do not contribute anything to income that is subject to the profits taxes it follows that it would be unfair to the government to permit a corporation to include in invested capital any asset that does not contribute income that is taxable.

Differentiate Between Bonds

Distinguish clearly between bonds owned by a corporation and bonds OWED by a corporation. The former are assets; the latter are liabilities. The terms "inadmissible" and "admissible" have no connection with liabilities.

Also, distinguish clearly between industrial bonds, which are obligations of a private concern, such as a manufacturing company, or a transportation corporation, and bonds issued by a state, city, county, or, etc., which are obligations of the public. Industrial bonds are admissible assets because the interest from them is subject to tax. The others are inadmissible because the interest they return is not subject to tax.

In this connection, you may have to exercise a great deal of caution in certain instances. For example, bonds might be issued by the Logan County Irrigation Project. You would have to ascertain whether these bonds were issued by the County of Logan, or by a private corporation doing business under this name. Similar conditions may arise in other lines of business, as road building projects, water companies, and other public utility enterprises, which may be owned by a municipality, or which may be owned by corporations.

If total assets are greater or less at the end of the period than at the beginning, or if the amount of inadmissibles carried has changed during the year, this method is not applicable. You will not have occasion to audit many cases of this kind, but occasionally one of such "turns up."

The Usual Procedure

(1) The first thing to do, when adjusting a balance sheet presenting inadmissibles, is to adjust each asset to its true invested-capital-value basis. See Article 818.

(2) The second operation is to find the total of the inadmissibles and the total of the inadmissibles AND admissibles.

(3) Ascertain the percentage rate that the inadmissibles bear to the total of the admissibles and inadmissibles.

(4) Compute the amount of the invested capital items.

(5) Use the amount found under (4) as a multiplicand and the percentage found under (3) as a multiplier. The product is the amount that must be deducted from the amount found under (4). Study Article 852.

Problem Illustrating the Above

We shall assume, for our present purpose, that all assets remained constant throughout the year.

The Harrison Manufacturing Co.
BALANCE SHEET
as at December 31, 1919

<i>Assets</i>		<i>Liabilities and Capital</i>	
Plant	\$250,000	Bonds	\$200,000
Patents	75,000	Reserve for Depreciation	25,000
Liberty Bonds.....	75,000	Capital Stock.....	325,000
Pa. Railroad Stock.....	25,000	Surplus	300,000
Pa. Railroad Bonds.....	75,000		
Municipal Bonds.....	50,000		
Edison Co. Stock.....	25,000		
War Finance Corpora- tion Bonds.....	20,000		
Real Estate.....	80,000		
Treasury Stock	25,000		
Goodwill	150,000		
	<hr/>		<hr/>
	\$850,000		\$850,000
	<hr/>		<hr/>

(1)—Referring to the sub-division just given—we find that all of the stock was issued July 12, 1916, at par value. We find that the treasury stock was purchased at par. Also, it is found that the patents were acquired for cash, and that stock was issued for the goodwill which was valuable.

Adjusted Balance Sheet

<i>Assets</i>		<i>Liabilities and Capital</i>	
Plant	\$250,000	Bonds	\$200,000
Less Deprecia- tion	25,000	Capital Stock..\$325,000	
	<hr/>	Less: Treasury Stock	25,000
Patents	75,000		300,000
Liberty Bonds.....	75,000	Surplus	225,000
Pa. R. R. Stock.....	25,000		
Edison Company Stock..	25,000		
Pa. R. R. Bonds.....	75,000		
Municipal Bonds.....	50,000		
War Fin. Corp. Bonds..	20,000		
Real Estate.....	80,000		
Goodwill	75,000		
	<hr/>		<hr/>
	\$725,000		\$725,000
	<hr/>		<hr/>

(2) Inadmissibles—

Pa. Railroad Stock.....	\$25,000
Municipal Bonds.....	50,000
War Finance Corporation Bonds.....	5,000
Edison Company Stock.....	25,000
	<hr/>
Total.....	\$105,000

(3) Total assets, \$725,000 divided into total inadmissibles equals 14.482%.

(4) Invested capital items—

Capital Stock.....	\$300,000
Surplus	225,000

$$\text{\$525,000} \times .144828 = \text{\$76,034.70}$$

(5)

$$\text{\$525,000} - \text{\$76,034.70} = \text{\$448,965.30} = \text{invested capital.}$$

Read Cumulative Bulletin. December, 1919, page 276—1-19-116.

Formula for Operations (3), (4), and (5)

The inadmissibles placed over the total of inadmissibles and admissibles times the invested capital items, thus:

$$\text{\$525,000} - \left(\frac{\text{\$105,000}}{\text{\$725,000}} \times \text{\$525,000} \right) = \text{\$448,965.30 invested capital.}$$

This formula is to be preferred to the first method of computation for the reason that an exact answer may be more readily obtained. In the first instance, unless the percentage rate is carried out to at least eight decimal points the answer will not be exact to a cent.

Pro-Rating (or Averaging) Inadmissibles

Article 852 tells us how to average the inadmissibles held during the taxable year, and states that when a "substantial change" occurs, the inadmissibles must be averaged as at the exact date that the change took place.

We are not told, however, what shall be regarded as a "substantial change." This appears to be left to the judgment of the auditor, and the procedure to be applied in any given instance should be based on the merits of each particular case. It is evident that a change that would be "substantial" in the matter of a small corporation, might be negligible in the case of a large corporation.

In the problems presented in this chapter we shall assume that all of the changes in inadmissibles during the taxable period are "substantial" changes.

Assets of the Union Company, as at—

	Dec. 31, 1918	Dec. 31, 1919
Cash	\$50,000	\$60,000
Plant	150,000	260,000
Chicago City Bonds.....	60,000	10,000
Liberty Bonds.....	30,000	30,000
War Finance Corporation Bonds.....	10,000	10,000
	<u>\$300,000</u>	<u>\$370,000</u>

Of the Chicago City Bonds, \$50,000 were sold December 2, 1919, at cost, and were not reinvested in inadmissibles.

Solution

It should be clear to you that to add the inadmissibles held at the beginning of the year to the amount held at the end of the year and arriving at an average by dividing by two, would not give us the true average for the reason

that the change took place so near the end of the period. To average them in that manner would produce—

Held at the beginning of the year.....	\$65,000
Held at the end of the year.....	15,000
	<hr/>
	2) \$80,000
	<hr/>
Average (?) thus obtained.....	\$40,000

Now let us find the true average. Inadmissibles to the amount of \$50,000 were sold December 2, 1919, therefore this amount was inadmissible for 335/365 of a year, or an average amount of \$45,890.41. This amount, plus the amount of inadmissibles that remained constant throughout the period, \$10,000 Chicago City Bonds, and War Finance Corporation Bonds to the amount of \$5,000 is the true average amount—

Amount Sold, prorated.....	\$45,890.41
Chicago Bonds (constant).....	10,000.00
War Finance Corporation Bonds.....	5,000.00
	<hr/>
The true average amount.....	\$60,890.41

Proof

Averaged amount of inadmissibles.....	\$60,890.41
Averaged proceeds of the sale; that is, \$50,000x	
30/365, or.....	4,109.59
	<hr/>
Amount of inadmissibles originally held.....	\$65,000.00

Had there been no inadmissibles at the beginning of the period, and had \$50,000 worth been acquired December 2, 1919, the average amount of inadmissibles would be $\$50,000 \times 30/365$, or \$4,109.59; in other words, the inadmissibles, when purchased, or when disposed of, during the

period, must be pro-rated over the entire year on the basis of the length of time they were held by the corporation, in order to arrive at the true average amount held.

Sold at a Profit and Other Income Received

Now turn to Article 817 and study it carefully. Let us quote: "Where the income derived from inadmissibles consists *in part* of profit from the disposition thereof, * * * a corresponding part of the capital invested in such assets shall be deemed an admissible asset."

We shall illustrate this Article by presenting the Balance Sheets of the—

Franklin Manufacturing Company as at December 31, 1918

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$50,000	Notes Payable	\$90,000
Plant	200,000	Capital Stock.....	400,000
Inventory	100,000	Surplus	210,000
Municipal Bonds.....	100,000		
Swift Stock.....	50,000		
State of Ohio Bonds....	100,000		
Pullman Stock.....	100,000		
	<hr/>		<hr/>
	\$700,000		\$700,000
	<hr/>		<hr/>

AND—

as at December 31, 1919

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$85,000	Notes Payable	\$80,000
Plant	270,000	Capital Stock.....	400,000
Inventory	140,000	Surplus	210,000
State of Ohio Bonds....	50,000	Undivided Profits.....	65,000
Liberty Bonds.....	100,000		
Standard Oil Stock.....	60,000		
Harvester Stock.....	50,000		
	<hr/>		<hr/>
	\$755,000		\$755,000
	<hr/>		<hr/>

The Solution

Remember, one thing at a time, is our slogan.

(a) We find that the municipal bonds, amounting to \$100,000, were sold May 1, at a profit of \$3,000, and that interest on these bonds, amounting to \$2,000 was received just prior to the sale.

Formula: Profit on sale.....	\$3,000
Interest received.....	2,000
	<hr/>
Total income.....	\$5,000
Profit $\frac{\$3,000}{\$5,000}$	$= \frac{3}{5}$
Income	\$5,000

The profit bears the same relation to the total income as three bears to five: hence—

$\frac{3}{5}$ of \$100,000=\$60,000, the amount that becomes admissible from January 1 to the date of the sale. This leaves \$40,000 inadmissible for the same length of time—120 days.

$120/365 \times \$40,000 = \$13,150.68$, the average amount of this inadmissible carried for the taxable period.

Since the proceeds were not reinvested in other inadmissibles, they become admissible from May 1 to December 31. The proceeds amount to \$105,000. The sale restored \$60,000 to admissibles, leaving \$45,000 to be pro-rated as at May 1 to December 31.

$$\$45,000 \times 245/365 = \$30,205.48.$$

Proof

Restored by sale at a profit.....	\$60,000.00
Averaged (admissible) proceeds.....	30,205.48
Inadmissibles averaged over the period.....	13,150.68
	<hr/>
Total averaged amount of this asset.....	<u><u>\$103,356.16</u></u>

This produces a larger asset amount than we began with, due to the (averaged) addition of the \$5,000 profit and other income. If we average (or pro-rate) the \$5,000 separately and deduct the result from the above total averaged amount of the asset, the remainder should equal the amount that we started out with; namely, \$100,000.

$$\$5,000 \times 245/365 = \$3,356.16$$

$$\$103,356.16 - \$3,356.16 = \$100,000 \text{ the original amount.}$$

(b) The Swift stock, we find, was sold at a profit of \$2,000 and no other income was received from this source; hence, the entire amount, \$50,000, becomes admissible from January 1 up to the date of the sale, June 29, 1919.

Note that Article 817 states: "Where the income * * * consists in part * * * ." Under (a) only a part of the income was taxable—a $3/5$ portion; therefore, only $3/5$ was restored. In this instance, all of the income is taxable; hence, the entire amount of the holding becomes admissible up to the date of the sale.

Profit on sale.....	\$2,000
Other income.....	0,000
	<hr/>
Total income	\$2,000

\$2,000 profit over
\$2,000 total income $\times \$50,000 = \$50,000$, the amount to be restored
 for a period of 180 days.

This asset and its proceeds would have been deemed admissible for the entire year, but for the fact that \$50,000 of the proceeds were immediately reinvested in Harvester Stock—another inadmissible.

So now we have $\$50,000 \times 180/365 = \$24,657.53$, the average admissible portion, and—

$\$50,000 \times 185/365 = \$25,342.47$, the averaged inadmissible portion.

Of course, the profit in the transaction, \$2,000 is admissible, since it was not reinvested in inadmissibles. It is too small an amount to pro-rate, coming as it does, so near to the middle of the year. See the sub-head "Proceeds" appearing near the close of this chapter.

Note: You will have observed that we are averaging these changes as at the exact date of occurrence. In the problem presented in Article 817, the computation is not fully carried out. See Article 852, 11th line, which directs: " * * * the effect of such change shall be averaged exactly from the date on which it occurred."

(c) The State of Ohio bonds, to the amount of \$50,000 sold for \$54,000, August 1, 1919. Interest amounting to \$4,000 was received just prior to the sale. The receipts were not reinvested in inadmissibles.

Profit on the sale.....	\$4,000
Interest received.....	4,000
	<hr/>
Total income.....	\$8,000

Profit to total income is as 4 to 8, or one-half. One-half the holdings became admissible up to the date of the sale; $\$50,000 \times 212/365 = \$29,041.09$, average amount restored.

Total holdings at beginning of the period.....	\$100,000
Amount remaining constant.....	\$50,000.00
Amount restored for 212/365 years.....	29,041.09
Receipts $\$58,000 \times 153/365$ years.....	24,312.33
	<hr/>
	\$103,353.42

Now if we deduct from this amount the \$8,000 interest

and profit received, averaged for 153/365 of a year, we should arrive at the original holding of \$100,000, which will prove the correctness of our computations.

$$\$8,000 \times 153/365 = \$3,353.42.$$

(d) On November 3, 1919, the Pullman stock was sold at cost and immediately reinvested in Liberty bonds—an admissible asset.

$\$100,000 \times 305/365 = \text{average inadmissible} \dots\dots\dots$	$\$83,561.64$
$\$100,000 \times 60/365 = \text{average admissible} \dots\dots\dots$	$16,438.36$

These two amounts added equal the original holdings and prove our computation.	<u><u>\$100,000.00</u></u>
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(e) The Standard Oil stock was purchased December 2, 1919.

$\$60,000 \times 30/365 \dots\dots\dots$	$\$4,931.51$
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The \$60,000 used to purchase this stock was admissible for 335/365 of a year, or.....	<u><u>55,068.49</u></u>
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Total amount involved.....	<u><u>\$60,000.00</u></u>
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THE AVERAGED BALANCE SHEET

It should be clear to you that to add to the admissibles held at the beginning of the period the admissibles held at the end of the period and divide by two, and then to this amount add the averaged amounts of admissibles already obtained (some disposition must be made of those figures) would be entirely wrong. It would, in reality, be equivalent to averaging some of the items twice, and upon different bases. To overcome this difficulty we have evolved the following—

Rule for Averaging the Balance Sheet

To the sum of the averaged inadmissibles add the sum of the previously-averaged admissibles. Deduct this total

from the balance sheet totals as at the beginning of the period and as at the end of the period. Add the remainders and divide by two. This will average all that have not been previously averaged. To the quotient obtained by dividing by two, add the sum of the previously-averaged admissibles (those that were involved in the changes). The total will be the average admissibles for the period. We already have the average of the inadmissibles for the period.

Illustrating the Rule by Our Problem

	Admissible	Inadmissible
(a) Municipal bonds restoration.....	\$60,000.00	
The pro-rated proceeds.....	30,205.48	
Pro-rated inadmissible portion.....		\$13,150.68
(b) Swift Stock (including Harvester)....	24,657.53	25,342.47
(c) Ohio bonds, constant portion.....		50,000.00
Restored by sale at a profit.....	29,041.09	
Pro-rated receipts.....	24,312.33	
(d) Pullman stock.....	16,438.36	83,561.64
(e) Standard Oil—admissible portion in- volved	55,068.49	
Inadmissible portion.....		4,931.51
	<hr/>	<hr/>
	\$239,723.28	\$176,986.30
Balance sheet totals—	at beginning	at end of period
	\$700,000.00	\$755,000.00
Less the total of the above sums: that is.....	\$239,723.28	
plus	\$176,986.30	416,709.58
	<hr/>	<hr/>
	\$283,290.42	\$338,290.42
Added and averaged.....	338,290.42	
	<hr/>	
	2) 621,580.84	

\$310,790.42 = the average of

the assets not entering into any of the transactions involving inadmissibles.

To this we must add the average of the affected admissibles and the affected inadmissibles—

Above average brought down.....	\$310,790.42
Average admissibles as above.....	239,723.28
<hr/>	
Total average admissibles.....	\$550,513.70
Total average inadmissibles.....	176,986.30
<hr/>	
Average of all assets.....	\$727,500.00

Now, while this result is just the same as we would have obtained (proving the correctness of our computations) had we averaged the sum of the total assets held at the beginning of the period and at the end of the period, the component parts (that is, part one, admissibles; part two, inadmissibles) are much different, as we shall show—

Inadmissibles at the beginning.....	\$350,000
Inadmissibles at the end.....	160,000
<hr/>	
	2) \$510,000
False average of inadmissibles.....	\$255,000
Admissibles at the beginning.....	\$350,000
Admissibles at the end.....	595,000
<hr/>	
	2) 945,000
<hr/>	
False average of admissibles.....	\$472,500

The invested capital items amount to \$610,000. Assuming that the 1918 income tax paid in 1919 amounts to \$100,000, and reducing surplus by .422603 of this amount, leaves a net invested capital (provided no inadmissibles had been carried) of \$567,739.70. Since inadmissibles were

carried, this amount must be further reduced in accordance with Article 854, beginning with line 13. (See formula given previously in this chapter.)

$$\$567,739.70 - \left(\frac{\$176,986.30}{\$727,500.00} \times \$567,739.70 \right) = \$429,619.91.$$

which gives us the net amount of invested capital.

Inadmissibles Sold at a Loss

In the event that an inadmissible is sold at a loss, the asset would be inadmissible up to the date of the sale, and the proceeds, if not reinvested in inadmissibles, would be admissible from the date of sale up to the end of the taxable period.

If the proceeds, on the same day, were reinvested in inadmissibles, the amount reinvested would be inadmissible from the date of the sale up to the end of the period. In arriving at the average amount, it is not necessary to pro-rate both the asset sold and the asset acquired. Simply pro-rate the amount of the loss, or the difference between the amount originally carried and the amount carried after the sale and the reinvestment.

To illustrate: The Morgan Stove Company carried municipal bonds amounting to \$50,000, as at the beginning of the year. May 1 the bonds were sold for \$45,000 and the proceeds were reinvested in Coppers.

It is evident that \$45,000 of the assets were inadmissible for the entire period, and, in addition, \$5,000 would be inadmissible for 120 days; that is, up to the date of the sale of the municipal bonds.

$$120/365 \times \$5,000 = \$1,643.84.$$

To this amount add the constant amount, and we have a total of \$46,643.84, the average amount of this inadmissible for the period.

Inadmissibles Exchanged for Admissibles

A transaction of this nature should be treated precisely as we treat a sale of inadmissibles; that is, the holding is inadmissible up to the date of the exchange, and the asset received for it (in other words, the proceeds, received in the form of property) is admissible from the date of the exchange up to the end of the period.

Should an inadmissible be exchanged for an intangible, the procedure would be just the same as if the intangible had been purchased for cash—in other words, it would be includable in invested capital at the full value given in exchange for it, and would not come within the 25% limitation.

Stock Held in Foreign Corporations

Many domestic corporations hold stock in foreign corporations. Sometimes this stock might be admissible and sometimes it might be inadmissible, dependent upon the following conditions:

(a) If the foreign corporation receives income from sources within the United States, then whatever amount of its stock that is held by a domestic corporation is inadmissible. See April, 1920, Digest (No. 9), page 189, 24-19-576.

(b) If the foreign corporation does not receive income from sources within the United States, then whatever amount of its stock that is held by a domestic corporation is admissible. For example, take the case of the—

Barnes Manufacturing Company

BALANCE SHEET

as at December 31, 1919

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$60,000	Notes Payable.....	\$90,000
Vera Cruz Oil Stock.....	75,000	Capital Stock.....	200,000
London Tramway Stock..	75,000	Surplus	210,000
Sundry Assets	290,000		
	<hr/>		<hr/>
	\$500,000		\$500,000
	<hr/>		<hr/>

Upon investigation it is learned that the Vera Cruz Oil Company receives income from sources within the United States; hence, any of its stock that is held by a domestic corporation is an inadmissible asset.

It is found that the London Tramway Company does not derive income from sources within the United States, therefore, any of its stock that is held by a domestic corporation is an admissible asset.

The reason for this is to be found in our general rule for determining the status of any asset, as stated on a preceding page, under the caption, "The Dividing Line." The income received by a domestic corporation from stock held in the Vera Cruz Company would not be taxed, because the income that the Vera Cruz Company received from sources within the United States has been taxed in the hands of the Vera Cruz Company, or in the hands of its agents in the United States.

In the matter of the London Tramway Company, the income received on stock held by a domestic corporation would be taxable for the reason that it had not previously been taxed by the United States Government.

Organization Expenses, Etc.

Inasmuch as organization expenses, amounts expended for the development of patents (which have not been made a charge against net income), or to protect title to property, and similar items, are not embraced in the list of inadmissibles previously given in this lecture, they must be given the status of admissible assets.

The question is often asked, whether or not organization expenses should be included in invested capital. To find an answer to this question it is only necessary to answer another question: Do we allow organization expenses as a deduction from gross income at deriving at net taxable

income for any period? We do not. Hence it follows that organization expenses, since they are not a deduction, must be included in invested capital to the extent that they have not been amortized. It is good accounting practice, of course, to amortize organization expenses over a short period of years, say three to five years, and this course is followed by many corporations so that sooner or later all such expenses disappear as invested capital and have been charged off through Surplus. Note, however, that if the corporation has made these expenses a charge to Profit and Loss, thereby reducing net income, the amount charged off must be restored to net income precisely as we would restore a donation that had been charged to Profit and Loss.

It would seem only fair dealing to restore to invested capital any legitimate amount of organization expenses that had previously been charged off, either through Profit and Loss or through Surplus. This harks back to our previous statement: An item must either be allowed as a deduction or it must be included in invested capital.

Status of Inadmissibles Held by Trustee

Let us assume that the X Corporation is required to establish a Sinking Fund for the redemption of bonds, or for any other purpose, and that this Sinking Fund must be placed in the hands of a trustee, as is quite customary. The corporation turns over the fund in the form of cash to the trustee. The cash is, of course, an admissible asset. The trustee takes the cash and invests it in Municipal Bonds. Here is a condition that has been the cause of considerable confusion in the minds of many auditors—the status of these bonds. It is contended by some that inasmuch as the corporation placed cash in the hands of a trustee (and some cite the fact that the trustee might be a bank) that the asset represented by the fund would be regarded as an admissible asset of the corporation. This

is an incorrect view as will be apparent when it is understood that the trustee is merely acting as the agent of the corporation. Any asset he holds must be given the same status that that asset or a similar asset would be given if held by the corporation.

“Proceeds”

A good many auditors have contended that the word “proceeds” as used in Article 817, Regulations 45, does not contemplate the inclusion of the profit made in the sale of an inadmissible—that the word means only the amount derived from the sale which represents the return of investment. It is difficult to see how any one who knows the meaning of the word “proceeds” could take such a position, but since many do, it is felt that attention should be called to the matter. “Proceeds” means that which is received in return for something—the total amount of it, whether it be profit or whether it be original investment. If a concern sells stock for \$1,000 that cost \$900, the proceeds of that sale are \$1,000 and are made up of the original \$900 investment and the \$100 profit.

Dealers in Securities

Stocks, Municipal Bonds and other inadmissible assets, when held by a dealer in securities, are inadmissible notwithstanding the fact that they might embrace the total assets of the concern. Of course, when any of such holdings are sold by the concern at a profit we would restore to admissibles the same proportion of the asset as we would were it held by an industrial concern. Some are inclined to think that this is not fair—that in the case of a dealer in securities inadmissibles held comprise the concern’s inventory and should have the same status that would be given an inventory of a mercantile concern. The law makes no exceptions; Article 817 makes no exceptions, and the

only thing left for the auditor to do is to be guided by the law and Regulations.

Cardinal Points

The thing to be determined is: Is the income (interest or dividends) that the corporation received or might have received from an asset taxable? If it is not, the asset is inadmissible.

The only income received or receivable on an asset that renders it inadmissible is non-taxable INTEREST or non-taxable DIVIDENDS.

Industrial bonds are admissible assets.

This chapter defines the treatment of inadmissibles as required by the 1918 Act. Do not attempt to apply the same method of treatment to inadmissibles reported in a 1917 return. There is no similarity in the two methods of treatment.

Inadmissible assets sold at a profit renders a portion of the asset (and, perhaps all of it) admissible.

When adjusting a balance sheet, consider only one thing at a time.

An Intentional Omission—Not an Oversight

Article 817, (b), has something to say about restoring inadmissibles by reason of the non-deductibility of certain interest paid.

Some of the best accountants in America have labored with this subject, only finally to admit that they do not know what is the correct procedure. The writer of this book dares not venture in where angels fear to tread.

Further, the writer does not believe you will ever have occasion to make use of this portion of the law. At any rate, you will have no need to until such time as some corporation is found that is honest enough to tell us that it borrowed certain money with which to purchase an inadmissible. We know of no other way of finding out that there was "interest incurred or continued to purchase or carry" an inadmissible. You can't "tag" a dollar.

CHAPTER ELEVEN

DEPRECIATION—OBsolescence—AppRECIATION

Definitions

The effect on net income of the functioning of depreciation, depletion, and obsolescence is identical, in that any one of them, when allowable, reduces the taxable income, but this is the only instance in which they harmonize. The meanings of the terms differ greatly, and so do the reasons for allowing a deduction from gross income when any one of these factors is to be considered.

(a) Depreciation is the result of the action of the natural law of wear and decay upon all things made by man and is based on the usable life of the asset. Depreciation applies, also, to some things not artificial (as live stock purchased, if not purchased for resale). The actual effect of depreciation is to reduce the value of that which remains.

A building is erected at a cost of \$10,000. At the moment of completion it is worth that, and its presumptive life is twenty years. At once deterioration enters into every piece of material in the structure; that is, it is depreciating. At the end of one year one-twentieth of the value has vanished—it is worth but \$9,500—that is the value that remains. The same thing takes place the second year, and so until the structure has ceased to be usable.

(b) Depletion has no effect upon the value of that which remains (unless it be to increase that value by les-

sening the available supply). Depletion represents the amount by which the volume is reduced in quantity units. It operates only upon natural resources, such as coal, or timber, and on nothing made by man.

Jones buys a vein of coal. It contains, according to competent engineers, 100,000 tons. The coal does not depreciate, but any amount of coal removed from the mine *depletes* it to the extent of the removal. If 10,000 tons are removed the first year, the mine has suffered depletion to that extent and if the unit cost is, let us say, 20 cents a ton, the depletion in dollars amounts to \$2,000, and Jones' books should show a depletion valuation account of \$2,000 in one of two ways—

First:

<i>Assets</i>		<i>Liabilities and Net Worth</i>	
Mine	\$20,000	Notes Payable.....	\$6,000
Less Reserve for Depletion	2,000	Capital Stock	12,000
	<u>\$18,000</u>		<u>\$18,000</u>

Second:

<i>Assets</i>		<i>Liabilities and Net Worth</i>	
Mine	\$20,000	Notes Payable	\$6,000
		Reserve for Depletion.....	2,000
		Capital Stock	12,000
	<u>\$20,000</u>		<u>\$20,000</u>

(c) Obsolescence, generally, is applied to things made by man, and is based, not on the number of years that the

asset may be usable, but on the period of time that it is found to be not useful for the purpose for which the asset was intended. Avoid the dictionary definitions of these three terms—they may confuse you, and they are of no aid to you in income tax work.

Smith has certain gear-cutting machines. They are in splendid condition and will do perfectly the work for which they were bought. Brown is a competitor of Smith. He acquires a newly-invented machine that will do as good work as the Smith machines, but at a greatly reduced cost. Smith can no longer compete with Brown unless he, also, installs the improved machines, which he does. His older machines have not depreciated to such an extent as to render them valueless, but they, through the introduction of improved machines, have become obsolete, hence he can change off as obsolescence (provided he discards the old machines) the cost of the older machines less the depreciation already charged off and less any salvage value they may have.

The operation of all three of these income-reducing factors may be illustrated, compared, and contrasted in the following abridged statement of a case:

The Hobart Mining Company began operations January 1, 1918. Lot "A" of the machinery cost \$30,000, and lot "B" cost \$22,000; all machinery having a five-year life.

Competent mining engineers estimated that the content of the mine was 1,000,000 units; the cost per unit, ten cents.

In 1918, 50,000 units were removed. This is the amount of depletion; that is, the mine has been depleted to the extent of 5% of the amount it originally contained. Since the unit cost was ten cents, it is evident that the depletion

value is \$5,000, and this is the amount that the company may deduct from gross income, as representing, not profit, but the return of \$5,000 of its capital. If this return should be distributed to the shareholders the invested capital of the company would be reduced by a like amount, pro-rated as at the date of distribution.

On December 31, 1918, 20% of the cost of the machinery was charged to depreciation. The machines are not depleted—they are partly worn out—they have depreciated in value. If we did not permit the company to deduct this amount in arriving at net income, we would be taxing the capital of the company in an amount equal to the amount of depreciation.

On June 30, 1919, lot "B" of the machinery equipment is found to be no longer adapted to the work of this mine, or it may be scrapped for some other equally good reason; there may be machines on the market that will do more work in the same length of time, or the same amount of work with less operatives, etc. The company decides to install new machines, more suited to the work. Here is where obsolescence comes in. The old machines are sold to another concern engaged in mining of a different nature. The sale price is \$8,000, and the loss is chargeable to obsolescence. How much is the loss? Is it \$14,000? Let us see—

Cost of lot "B".....	\$22,000
Capital returned by depreciation..	\$6,600
Capital returned by sale.....	8,000
	<hr/>
Total amount of capital returned..	14,600
	<hr/>
Deductible loss for 1919.....	\$7,400

Why Depreciation?

For a concern (or an individual) to pay out the apparent earnings without making sufficient allowance for depreciation, would be equivalent to liquidation of capital. It is conceivable that such a procedure might be continued year after year until such time as the plant and equipment were worn out, with nothing on hand with which to replace them—all of the original investment having gone out in the form of dividends.

The object of computing depreciation, with regard to income tax, is to give to the taxpayer such a portion of his gross income as shall reimburse, or return to him, such an amount of the original investment as may have disappeared by reason of wear and decay of his equipment or other depreciable asset.

The wear and decay (usually called "wear and tear") may not always be apparent, but it is present. Purchase a new hat today. Tomorrow it will appear to be precisely as good as it did the moment you purchased it. On the third day you will see no difference between its appearance then and its appearance on the second day. But IS it the same? It is not. If it were it would last forever. Every moment of time from the moment you purchased it it is becoming of less value—its period of usefulness is becoming shorter, until finally it must be discarded.

And so it is with many of the assets of the taxpayer. Each moment of time they are of less value than at any preceding moment. Like the hat, this lessening of value is usually not apparent. This fact must be faced—ALL PROPERTY IS DETERIORATING at a more or less rapid rate. Some critics, having a hobby for precision of statement, might say that this assertion is too broad, and might cite money and land as exceptions. Not catering to the idiosyncrasies of hobbyists, we will not discuss this point here.

But do not be misled. When we state that all property is deteriorating we do not mean to say that depreciation is allowable on all property, for such is not the case.

Bear in mind that depreciation must be provided for before net profits can be ascertained just as surely as that cost of labor, or of supplies, must be considered.

There can be no profits until all expenses are taken care of and depreciation is as certainly an item of expense as are light and heat, or rent and insurance. It may be a little difficult to see that depreciation is an expense owing to the fact that actual money is not being paid out month by month or at other stated periods of time.

Suppose we put it in this light: John Adams goes into the furniture manufacturing business. He buys from Uriah Morse a machine called a "shaper." It cost \$1,000 in cash. Morse tells Adams that the shaper will last just ten years, and Adams, being a practical mill man, knows this statement to be true.

Morse proposes that if Adams will give him \$100 each year (disregarding, for the moment, the compounding of interest) for ten years that at the beginning of the eleventh year he will give Adams a new shaper of the same model as the old one.

Don't you think that Adams, when he is paying out these hundred dollar amounts, would fully realize that depreciation is an expense? He would know that he was giving Morse the money for the purpose of placing his shop, at the end of ten years, in just the same state of efficiency as when he began business and that during the ten-year period he had suffered an expense of exactly one thousand dollars in the wear of machinery; that a little portion of that value had gone into each piece of wood he had shaped—kept on going until no value remained.

Let us illustrate it this way: Adams purchased a large quantity of lumber and stacked it in one pile. The first thing he made was a table. Wishing to know at what price he must sell tables in order to make a profit, he set down cost items; labor, rent, power, varnish, etc. Not knowing the exact amount of lumber used, he glanced at his lumber pile and thought: "The pile appears to be as big as it was before I made the table; 'I'll not consider the cost of the lumber.'" Would such procedure be business-like? Of course it would not, but it would be just as reasonable as it would be for him to glance at the shaper and say, "I can see no wear; it's as good as new, therefore I will not consider depreciation."

Methods of Computing Depreciation

There are seven or eight methods of computing depreciation. The Regulations do not require any particular plan, but leave it optional with the taxpayer, so long as the method adopted is a recognized one and is explained in the return of the taxpayer. See Article 165.

Of the several methods in use, only two receive much consideration outside of text books. These two are the "Straight-Line Method," and the "Declining Value Method."

Of these two, the first-named is used much more frequently than the other, due perhaps, to the complexity of the computation required in following the second method.

Of the other methods, as the Annuity Method, the Revaluation Method, Composite Life Method, etc., nothing need be said, as it is unlikely that you will ever have occasion to use any of them unless you should follow the profession of public accounting.

The Straight-Line Method

This method consists simply of dividing \$1 by the probable number of years' life of the asset to obtain the rate of percentage to deduct from the cost of the asset at the end of each accounting period. Or (and this amounts to the same thing) dividing the cost by the number of years, to find out the lump amount to allow for depreciation at the end of each period.

To illustrate: A new stamping machine is bought at a cost of \$6,000, and it has an estimated life of twelve years. One dollar divided by 12 gives a percentage of $8\frac{1}{3}$. Multiplying \$6,000 by this percentage gives us \$500 as the amount of yearly depreciation. Or, the other way: \$6,000 divided by 12 gives us the same amount—\$500.

Sometimes this method is modified so as to provide a more equitable distribution of the (depreciation) expense, in cases where the residual, or scrap value, is fairly ascertainable. Thus, a concern purchases a new machine at a cost of \$7,700 cash. Experience has taught that this machine should last 16 years, and at the end of that time the machine will have a salvage value of \$500.

If depreciation is based on a cost of \$7,700 and this amount is charged off, and later \$500 is realized on the residual, it should be clear that here is, in effect, a double return of capital investment to the amount of \$500. If, on the other hand, no depreciation were charged off for the last year, the profit reflected by the Profit and Loss Statement would be inflated by \$500, or the books would have to be "juggled" to reflect the true profit for the period.

To overcome this objectional feature, the residual value is deducted from the cost price and the remainder is the basis or amount that is distributed over the life of the asset in way of depreciation. Seven thousand and two hun-

dred dollars divided by 16 gives \$450, the amount to be charged to depreciation at the end of each accounting period. Algebraically it would be expressed thus:

$$D = \frac{V - R}{Y}$$

in which D indicates the annual depreciation, V represents the cost or value, R indicates the residual, and Y the number of years of life.

Unequal Percentage Method

This is another name for the "Straight-Line Method." A property valued at \$1,000, life ten years, is depreciated, let us say, at the rate of ten per centum on the cost. This is an unequal percentage method, notwithstanding the fact that we use ten per centum each period. The first year the depreciation is \$100, or 10% of \$1,000. The second year it is another \$100, but the value of the property is now only \$900, so that \$100 depreciation on a value of \$900 is a trifle more than 11%. This rate would increase as the years went on. The equal percentage method is to be found in the Declining Method, mentioned previously. By this method we must ascertain that percentage, which when applied to the declined value of each year, will render, at the end of the life of the asset, a return of capital that shall equal the cost less the residual or salvage value.

The Declining Value (or Fixed Percentage) Method—

is a much more complicated scheme than the Straight-Line Method. It is sufficient for the purpose in hand simply to illustrate its application. As to how the rate of depreciation is obtained, you are referred to your old-time logarithmic days and the tables you pored over at that time.

Proposition :

A certain piece of machinery cost \$1,000. It is estimated that the machine will last five years, and that the residual value will be \$200. By the use of logarithms we find the depreciation rate to be $27\frac{1}{2}\%$. The following table gives the amount of depreciation to be charged off at the end of each year to leave a residual of \$200:

Year	Value as at January 1	Depreciation for the year
1	\$1,000.00	\$275.00
2	725.00	199.38
3	525.62	144.54
4	381.08	104.80
5	276.28	75.98

Total charged off.....\$799.70

Cost, \$1,000, less \$799.70 charged off, gives a salvage amount to be realized of \$200.30. Had the decimals been carried out far enough the last-named figure would have been \$200 within a fraction of a cent. A few cents, in such a case, is immaterial—whether the amount be a little more or a little less than the amount of residual originally estimated.

You will note that, theoretically, where there is no residual value, as in a franchise, or a lease, this method can not be employed unless a fictitious or nominal value is set up, as one cent, or one dollar to act as the residual-value element in the formula.

Percentage of Depreciation

It is not possible to furnish a schedule of rates of depreciation that can be applied to all cases, or even to a majority of cases. An occasional asset item may be found

for which a standard percentage rate can be named, as in the case of furniture and fixtures, which is usually placed at ten per centum, but even the percentage rate in this instance may vary. I have seen a rate as high as twenty and one as low as five, and in those particular cases, the rate claimed was considered equitable.

Many items vary greatly in the rate of allowance. Some kinds of machinery may have useful lives of only four or five years, while other machines may be expected to last for a period of twenty or more years. Some tools and equipment may last for twenty or more years; others for only a few years or a few months. Where the useful life is only a matter of a few weeks or months, or even one year, they would, of course, be chargeable to current expense, for the result would be the same were they to be capitalized and depreciated.

A printing concern may have presses that will last 30 years, composing sticks and galleys (barring obsolescence, of course) should last many years, while type, if it be given reasonably constant use, will do well if it lasts four years.

Tools used in cabinet work ought to last from ten to twenty years while painters' tools may last but a few months or weeks. I have in mind an actual case: A plastering corporation in its return deducted 50 per centum depreciation on its equipment of ladders, scaffolding, trowels, hoes, hods, etc. An agent was asked to investigate. The result was that he allowed all that was claimed. If you will think a moment you will see that he was right in so doing.

The life-years given in the following table should be regarded as only suggestive. For the percentage rate in any given case, divide \$1 by the number of years of life. It may be that some of the percentages would be applicable

to the usual run of cases, but in each individual case the auditor must exercise care and judge each case on its merits for so many factors enter into the question of depreciation that a rate which would be fair for one concern might be unjust for the next.

<i>Item</i>	<i>Life-years</i>
Furniture and Fixtures.....	10
Frame buildings (temporary buildings, but a few years) .	20 to 40
Brick buildings.....	30 to 50
Concrete buildings.....	50 to 75
Concrete-Steel buildings.....	75 to 100

Real estate (apart from improvements) NO DEPRECIATION ALLOWED.

Woodworking machinery, printing machinery, and machinery used in light manufacturing, any life period ranging from 10 to 25 years.

Heavy machinery, such as concrete mixers, stone crushers, stamping machines, mine machinery, punching and die cutting machines, machines used in steel mills and the larger machine shops, etc., has a life of from 5 to 10 years.

Machines of precision, such as those used in the manufacture of watches; the various glasses, astronomical and others; chronometers, optical instruments, drafting tools, surgical instruments, etc., while they may have a long life, they are apt at any day to become useless, either from obsolescence or due to the fact that they no longer are capable of turning out accurate product.

The period of usefulness of automobiles, motorcycles, bicycles, trucks, delivery wagons, and other conveyances is short—usually about five years.

The life of water craft is longer than the life of conveyances used on land and the depreciation rate is usually low. See Bulletin 9-20, page 14.

Depreciation Must Be Charged Off

In order for the taxpayer to take advantage of a deduction for depreciation, the depreciation must be charged off. The specific manner in which this is to be done is left to the taxpayer. The following Balance Sheets illustrate the two methods mentioned in Article 169 (which see).

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$50,000	Capital Stock.....	\$150,000
Receivables	50,000	Allowance for Deprecia-	
Plant	150,000	tion	15,000
		Surplus	85,000
	<u>\$250,000</u>		<u>\$250,000</u>

OR—

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$50,000	Capital Stock	\$150,000
Receivables	50,000	Surplus	85,000
Plant	\$150,000		
Dess Deprecia-			
tion	15,000		
	<u>135,000</u>		
	<u>\$235,000</u>		<u>\$235,000</u>

To obtain the true value of the assets by the first method given above, the Valuation Account (Allowance for Depreciation) must be deducted from the asset total. In the second method, the Balance Sheet shows at a glance the true value of the assets.

Depreciation and Repairs

Ordinary repairs are a deductible expense item and are allowable in addition to the depreciation deduction. But a distinction must be made between what are clearly repairs

necessary to keep the machine in an efficient, running condition and repairs (really improvements) which appreciably prolong the life of the machine. The latter items must be classified as capital expenditures, and are not deductible items, but they are, of course, depreciable over subsequent periods. Take the case of an automobile; a new set of spark plugs would be considered as repairs, and be deductible as expense, while the installation of a new engine would have the effect of making an almost new machine out of an old one, and should be classed as a capital expenditure. See Article 103.

Discarded Property—Illustrated

During January, 1920, the Reliance Machine Company discarded machines that cost, in January, 1914, \$15,000. The company had charged off depreciation during this period to the amount of \$7,500, which was the correct amount. The discarded machines were sold for \$1,500. The return of capital amounts to the sum of the depreciation charged off plus the salvage value, or a total return of \$9,000. How shall the company proceed to secure the return of the remainder of its investment in these machines without being taxed on this amount? The answer is: It may deduct, as a loss, in its return for 1920, the unreturned amount—\$6,000.

In January, 1920, the Everett Cotton Mills discarded looms for which the corporation paid \$15,000 in January, 1914. No depreciation had ever been taken in its tax returns and none had ever been charged off. The looms were sold as junk and \$1,000 was realized on the lot. May it take a loss of \$14,000 in its 1920 income tax return? No. It may deduct the difference between the amount of depreciation that should have been charged off PLUS the salvage value, and the cost price. We will assume that the machines would have had a normal life of ten years—depreciation rate 10%.

6 years x 10% = 60%	
60% x \$15,000 =	\$9,000
Salvage value.....	1,000
	<hr/>
Capital returned.....	\$10,000
Cost	15,000
	<hr/>
Loss deductible in tax return for 1920.....	\$5,000

As to how the taxpayer may recoup for the depreciation not charged off during prior years, see Digest for April, 1920, page 83; 30-19-639, S. 1217. Also, see Article 1561.

Extraordinary Depreciation

The Atlas Woodworking Company was a manufacturer of light cabinet work. Its machines, when used for that purpose, had a probable life of twenty years. Depreciation had always been charged off on that basis. In 1918, finding business falling off, it began the manufacture of large refrigerators and other heavy woodwork—things that should have been made on heavier and stronger machines.

Had the company so desired, it could have scrapped the machines and deducted as obsolescence the difference between the amount of depreciation already charged off and the original cost of the machines, LESS salvage value. It did not feel financially able (this particular reason is no determining factor—any reason causing the company to take such action would “get by”) to purchase a new outfit of heavier machines, so it continued to use the old ones, thereby imposing on the machines stress and strain in excess of the amount they were intended to withstand.

May this concern, from the date on which the machines were put to this new line of work, deduct a rate of depreciation greater than had been taken previously? Yes. See Digest, April, 1920, page 90, 16-20-862.

Almost the same condition would obtain where machines are run continuously. When it is stated that a machine has a life of fifteen years, it is meant that under ordinary working conditions, of, let us say, eight hours a day, that the machines should last for fifteen years.

If machines are run for twenty-four hours a day it is evident that they will not last fifteen years. It would not follow, however, that we should reduce the probable life to five years, for machines that are working only eight hours a day are depreciating at a more or less rapid rate during the sixteen hours of idleness, but probably not as rapid a rate as when running. In this instance we probably should give the machines a depreciable life of ten years.

A Profit in Place of a Loss

It sometimes happens that a taxpayer will claim a loss in the sale of property when, in actuality, a profit has been earned.

The Jewel Cutlery Company paid \$10,000 for a parcel of real estate. In July, 1914, it erected a building thereon at a cost of \$80,000. The life of the building is placed at fifty years. In January, 1919, the property was sold for \$85,000, and the company claimed a deductible loss of \$5,000 in its 1919 income tax return. Should this deduction be allowed? Let us see—

Property sold for.....	\$85,000
Depreciation on building for $4\frac{1}{2}$ years.....	7,200
	<hr/>
Amount of capital returned.....	\$92,200
Cost of property.....	90,000
	<hr/>
Taxable income.....	\$2,200

Replacement Value and Depreciation

In its 1917 return the Columbia Corporation deducted \$3,500 depreciation on its seven crimping machines. The machines were purchased in 1915 and were supposed to last for ten years. During 1918 it became necessary to purchase four additional (and identical) machines. Owing to the great advance in the cost of machinery of all kinds, the company was required to pay \$33,600 for the new machines.

In its return for 1919 the company deducted \$9,240 for depreciation on the eleven machines, on the basis that the replacement value of the seven machines is the same per machine as the cost of the new machines. Is this amount of deduction allowable? NO. The two fundamental facts to be ascertained in computing depreciation are—

- (a) The cost of the asset if acquired subsequent to March 1, 1913, or, if acquired prior to that date, its value as at March 1, 1913.
- (b) The probable life of the asset (based, where possible, on experience).

A third, but less important factor, might be mentioned—that of ascertaining the residual or salvage value.

What it might cost to replace an asset now is not indicative of what it may cost in the future. See April, 1920, Digest, page 90, O. D. 283.

In the case cited above, the company must depreciate the seven original machines on the basis of the cost of the seven and, in the case of the new machines, it must compute depreciation on the basis of the cost of the four.

Amount Recoverable Through Depreciation

The total amount of depreciation that a taxpayer may deduct over the life period of an asset is the capital sum

invested in the asset if acquired subsequent to March 1, 1913, or the value of the asset as at March 1, 1913, if acquired prior to that date, less the salvage value, if any.

LAND, apart from any improvements that may have been placed upon it, is NOT SUBJECT TO DEPRECIATION. Article 164 is very clearly stated and should be given careful study.

Reserve for Depreciation

Very frequently you will find on Balance Sheets the so-called Reserve for Depreciation. As stated in Chapter Eight, such a reserve can not be included in invested capital. Of course, if the reserve represents an amount in excess of the true depreciation, the excess of the reserve over the correct amount of depreciation should be included in invested capital.

Intangible Property and Depreciation

If Davis procures a copyright direct from the government, his invested capital, in so far as the copyright is a contributing factor, is the fee he paid the government, plus any attorney fees that may have been necessary, plus amounts expended for typists, or other clerical or professional aid, and any other legitimate expenses in connection therewith, and which were not charged or chargeable to current expenses.

If Davis purchased a copyright from another, his invested capital in the copyright is the amount he paid for it.

In either of the above events, if Davis found it necessary to defend his title to the copyright, whatever outlay was necessary in the litigation would be a part of, or an addition to, his capital invested in the copyright. Article 293.

The amount of capital invested in the copyright is the amount that may be the subject of depreciation, divided by the number of years of life of the copyright that are unexpired at the time of its acquisition by Davis.

If, during the legal life of the copyright, it becomes evident that it no longer has value, due to supersession, or to other legitimate reason, then the difference between the amount of depreciation already charged off and the amount invested in the copyright would be an allowable deduction as obsolescence.

Article 163, as given in the 1920 edition of Regulations 45, has been amended by the elimination of the last sentence: "There can be no such allowance in respect of goodwill, trade names, trade-marks, trade brands, secret formulae, or processes." This change makes the Regulations harmonize with the ruling given at the bottom of page 88 of the April, 1920, Digest. You are urged to study this ruling. As it is very concisely, as well as clearly stated, it seems unnecessary to add anything here by way of explanation. Also, study T. B. M. 39, Cumulative Bulletin, page 131. See Articles 167 and 170.

Patents

The conditions that apply to copyrights are also applicable to patents with the exception that it is not obligatory on the part of the taxpayer to charge off depreciation on patents. Make a close study of Article 843.

Depreciation of patents (as well as other depreciable property) acquired prior to March 1, 1913, should be based on the value established as at that date. Do not permit this statement to lead you to allow the value as at March 1, 1913, to be included in invested capital. The cost of the patent (or other property) is the amount allowable.

THE VALUE OF AN ASSET AS AT MARCH 1, 1913, HAS NO BEARING ON INVESTED CAPITAL, if such value is different from the cost. Cost, and only COST, is the determining factor in the computation of invested capital.

A Peculiar Condition or Result

Computing depreciation on the value as at March 1, 1913, sometimes leads to a singular condition, in that more depreciation may be charged off than the concern has invested in an asset, as you will note from the following:

The Sherwood Company purchased a patent in March, 1908, at a cost of \$17,000. Inasmuch as a patent runs for 17 years, the depreciation charged off each year amounted to \$1,000.

This patent proved to be very valuable and at March 1, 1913, it was revalued at \$120,000. From that date the patent had a life of twelve years, and depreciation was rightfully taken at the rate of \$10,000 a year. You will at once see that in less than two years more depreciation was charged off than the company had invested in the patent.

Realization of Appreciation

Take the last proposition presented—that of the revalued patent. Had the patent not been revalued the company would have charged off the books, up to January 1, 1918, depreciation amounting to \$9,833.33. On the basis of the revaluation, depreciation was charged off over the period from March 1, 1913, to January 1, 1918, amounting to \$48,333.33. Add to this the amount charged off during the first five years and we have a total of \$58,166.66. Thus we have—

Charged off on revaluation basis and prior years.....	\$53,333.33
Amount that would have been charged off had there been no revaluation.....	9,833.33
	<hr/>
Difference.....	\$43,500.00

This difference represents realization of appreciation, and, if not distributed and is in use in the business, it may be added to invested capital. See Article 844 (c).

Two things should be noted in this connection—

- (a) This is the only instance where any semblance of appreciation may be included in invested capital, and it has led many auditors to conclude that appreciation has been added to invested capital. Such is not the case. No appreciation can in any case be included in invested capital. In the instant illustration there is none added.

It is true that we actually are adding back an amount greater than the original cost of the patent, but note—we are not adding a cent to the patent; what we are doing is to add back to SURPLUS an amount that actually had been charged against Surplus periodically through Profit and Loss in excess of the amount that invested capital values permitted. Had such additional charges not been made, profits would have been larger, and, if not distributed, Surplus would have been an equal amount greater.

- (b) The revaluation must have been made as at March 1, 1913. Should it have been made at any other date, and should the taxpayer report the enhanced value as income and pay taxes thereon, the appreciation can not be included in invested capital. The government will not accept, or, will not retain,

any taxes paid on this fictitious income. See Digest for April, 1920, page 196, 7-19-308, T. B. M. 41.

There is another date for ascertaining fair market value, but it has to do entirely with natural resources.

Depreciation of Models

The Stokes Typewriter Company, during 1919, expended \$20,000 in having drawings, models, etc., made in an effort to improve its machine. Is this expense or is it capital expenditure and subject to depreciation?

The company may exercise the privilege of charging this amount to expense, or, it may set up the amount as a capital investment and depreciate it over the estimated period of usefulness of the several items. See Article 168.

Obsolescence of Buildings

One of the activities of the Penn Realty Company was the erection of an apartment house in what was then a very desirable residential district. It cost, January, 1914, \$80,000. It was let to a very desirable class of high-rent-paying tenants. In December, 1917, a factory was erected across the street from these apartments, and as a result, all of the tenants vacated as soon as the leases expired.

To avoid having an empty building on its hands the company found it necessary to fill it with factory employees at a low rental. The effect of this was to cause the building to be run at a loss in 1919.

The company claims that the building is obsolescent and in its 1919 return makes a large deduction for this reason.

Is this allowable? No. The building is still usable for tenant purposes and that is the purpose for which it

was built, and no deductions are allowable except depreciation, ordinary repairs, and the loss sustained in the operation of the building.

On the other hand, if the company had been aware, in December, 1918, let us say, that the locality was to become undesirable as tenant-rental property, and had it determined, that in January, 1921 (or at any other date), the building should be torn down, it could deduct obsolescence for the years 1918, 1919, and 1920, on the following basis:

Cost	\$80,000
Depreciation for 5 years at 3%.....	\$12,000
Estimated residual value.....	8,000
	<hr/>
Total return	20,000
	<hr/>
Obsolescence.....	\$60,000

The amount of obsolescence should be spread equally over the three-year period and \$20,000 deducted each year. See Bulletin 4-20-704, O. D. 381.

Appreciation Must Be Placed Where It Belongs

It is possible, though, perhaps, not probable, that the appreciation of the land would not be at the same rate as the appreciation of the improvements, or vice versa. Otherwise, of course, the rate of appreciation would be equal. The following propositions illustrate the amount of taxable income to be returned in two similar, yet dissimilar, cases—one in which the land appreciated and the building did not; the other, a case in which both appreciated ratably.

The cost, March 1, 1908, was, land, \$100,000; building, \$100,000. Life of building, 40 years.

Revalued as at March 1, 1913—

Proposition "A"

Land	\$200,000
Building	87,500
	<hr/>
Total value March 1, 1913.....	\$287,500

Note that the value of the building is placed at its original cost, less regular depreciation.

Proposition "B"

Land	\$150,000
Building	137,500
	<hr/>
Total value March 1, 1913.....	\$287,500

Note that both properties, as a whole, have the same value at the beginning as well as at the date of revaluation, and observe how this inequality in the rate of appreciation will affect the taxable income.

March 1, 1918, both properties were sold for \$300,000 each. What is the taxable income in each instance?

Under Proposition "A"—

Sale price.....	\$300,000.00
Five years' depreciation on the original cost.....	12,500.00
	<hr/>
Amount of capital returned.....	\$312,500.00
Value as at March 1, 1913.....	287,500.00
	<hr/>
Total taxable income.....	<u><u>\$25,000.00</u></u>

Under Proposition "B"—

Sale price.....	\$300,000.00
Five years' depreciation on revaluation as at March 1, 1913.....	19,642.85
	<hr/>
	\$319,642.85
Value as at March 1, 1913.....	287,500.00
	<hr/>
Total taxable income.....	<u>\$32,142.85</u>

It should be noted that in the years between March 1, 1913, and March 1, 1918, the corporation would be entitled to a larger deduction for depreciation in computing net income under Proposition "B" than it would be under Proposition "A"; therefore, during those years its tax under "B" would be less than under Proposition "A" provided, of course, that the gross income were equal.

Birthday of Income Tax Law

You will have observed that frequent reference has been made to the date, March 1, 1913. This particular date is the basis of many computations and adjustments for the reason that it is the Birthday of our present series of income tax laws.

The law of 1909 is commonly referred to as an income tax law, but this is misleading. It was an excise tax law, and perhaps the reason for its being called an income tax law, is the fact that the excise tax was based upon income.

Things Worth Remembering

1. Depreciation is an almost ever-present item of expense and must be charged off. Net income can not be

determined without first ascertaining the amount of depreciation expense.

2. The amount of net income a concern may report is overstated unless it has charged off sufficient depreciation for the period, and, conversely, if insufficient depreciation has been charged off in the past, invested capital is overstated.

3. The basis of depreciation is the cost of the asset if it was acquired subsequent to March 1, 1913, or the value of the asset as at March 1, 1913, if acquired prior to that date.

4. A change in the use to which a building is put, or a lessening of the value of a building by reason of a change in its surroundings, no matter what the cause of the change, gives no basis for a claim for deduction for obsolescence.

5. Patents may be depreciated, or they may not, at the option of the taxpayer.

6. The value of an asset as at March 1, 1913, bears no relation to the amount of invested capital that may be allowable. The amount a corporation paid for an asset, less the subsequent depreciation, obsolescence, or depletion that was or should have been charged off is the amount that may be included in invested capital.

7. A "Reserve for Depreciation" is not a true reserve—it is not allocated surplus—and can not be included in invested capital. See Article 1549.

8. Depreciation does not apply to inventories; neither does it apply to natural resources. See Article 162.

9. The total amount of depreciation that may be charged off with respect to a depreciable asset, is the cost of the asset if acquired subsequent to March 1, 1913, or

the value of the asset if acquired prior to that date. Hence, a concern that has depreciated an asset, let us say Furniture and Fixtures, for a period of ten years at 10% a year, cannot claim a deduction for depreciation of this asset for the eleventh or any subsequent year.

10. Appreciation, except to the extent that it is recognized in the revaluation of property (that has increased in value) as at March 1, 1913, is an unknown and unused quantity in income tax procedure. The allowing of revaluation of natural resources under certain conditions is, strictly speaking, not appreciation, for the value was there before the discovery, but partakes more of the nature of the determination of the amount to be valued—not re-valued.

Look Up These References:

O. D. 344, and O. D. 472, page 89, Digest for April, 1920.

Special Observation. Under the subheading, "Intangible Property and Depreciation," is a statement that is at variance with the Recommendation of the Committee on Appeals and Review, as given in Bulletin 20-20-934. Article 293 states, "The cost of DEFENDING or perfecting title * * * ." If words mean anything, the statement of the writer of this treatise is in complete harmony with Regulations, Article 293. Note that Article 293 does not differentiate between the two kinds of property—tangible and intangible—it says PROPERTY.

CHAPTER TWELVE

A. R. M. 106

It appears that the Memorandum from the Committee on Appeals and Review, commonly known as A. R. M. 106, has been the cause of a great deal of uncertainty and misapprehension in the minds of many persons in the Income Tax Unit.

Just why this should be so it is difficult to understand. Various individuals have had all sorts of ideas and notions concerning it. I have had able men in the audit tell me that under A. R. M. 106 appreciation must be allowed in invested capital. I have been told that taxpayers or taxpayers' representatives in conferences have stood up and shaken their fists, pawed the air, and defied the conferee to disallow appreciation, citing as their Gibraltar of defense A. R. M. 106. I have had able auditors tell me in class that A. R. M. 106 specifically provides for the inclusion of appreciated values in invested capital and that they could show it to me. On several occasions I have passed them a copy of the memorandum and asked them to do so. Needless to say, they were unable to do it.

All of us are prone to accept a thing as being difficult or ambiguous or incomprehensible when we are told by some one in whose ability we have confidence that such a one cannot understand a given statement. I believe that something of this sort has been the cause of the wave of uncertainty that has swept over the Unit regarding A. R. M. 106—somebody told somebody else that it was not understandable, and that assertion was repeated on down the

line until the rank and file came to believe it to be a fact, perhaps not taking the trouble actually to read it and fewer still taking the trouble to read it carefully and study it.

A. R. M. 106 did not change the Regulations an iota. It only emphasized Article 839, Regulations 45. As a matter of fact, there is quoted in the memorandum, as a justification for the memorandum, a portion of Article 839.

But let us take up the original A. R. M. 106 and analyze it and see what it does say. (The reference remarks embodied in the memorandum are interpolated by the writer.)

"The Committee is in receipt of a memorandum from the Income Tax Unit requesting advice relative to the practice of field agents in reducing earned surplus by deductions for depreciation where none had been claimed in the past, or where a lower rate has been claimed than is ordinarily allowable (a) with respect to the depreciable assets in question.

"It is the judgment of the Committee that there is no warrant for reducing earned surplus because of alleged failure (b) to charge off sufficient depreciation in the past, unless the depreciable assets of the corporation are valued on its books at the beginning of the taxable year at an amount in excess of their actual value (c) at that time. This is particularly true where the corporation in prior years earned positive income from which larger deductions for depreciation might have been taken, (d) if in the opinion of the officers and directors of the corporation such larger charges had been justified. Nothing herein is to be construed as precluding the Income Tax Unit from adjusting (e) depreciation, either by way of increase or decrease, where there is at hand affirmative evidence that as at the beginning of a taxable year the amount of depreciation written off in prior years was insufficient or excessive. The

correct attitude of the Bureau and the proper conduct of its field agents, in particular, are plainly set forth in that part of Article 839 of Regulations 45, which reads:

“Adjustments in respect of depreciation or depletion in prior years will be made or permitted only upon the basis of affirmative evidence that as at the beginning of the taxable year the amount of depreciation or depletion written off in prior years was insufficient or excessive, as the case may be.”

(a) “Ordinarily Allowable.” In my view that is the whole “meat in the cocoanut.” It were absurd to assume that the vast majority of corporations organized years ago deliberately charged off less depreciation in years prior to the advent of the excess profits tax than should have been charged off. As a matter of fact, during the years of the Excise Tax they would have been inclined to do the exact opposite of this. The average corporation that has continued for a number of years has been governed by directors having good, common sense and business acumen. Their desire was to charge off sufficient depreciation so that they would not, by declaring dividends, liquidate capital. The judgment of such men as to the life of a given machine or other asset is far better than the judgment of any one who has not been in a similar business for the same length of time under like conditions. For an auditor or an agent arbitrarily to state that the depreciation rate was too low in the past, under most conditions, is absurd. What has he to judge by that is superior to the basis of the judgment of those connected with the management of the concern? Nothing at all. Some seem to think that, because it is proper to depreciate a certain machine in a certain factory at the rate of 10%, that all similar machines in other factories should be given the same rate. This, too, is absurd. I may cite a case where an auditor insisted that the depre-

ciation rate should be 10% when, as a matter of fact, the machines, having been given only ordinary repairs, were fifteen years old and still in use.

I believe that A. R. M. 106 was promulgated solely to overcome this attitude—giving the average corporation of years' standing credit with being reasonably honest and having fairly good horse sense.

(b) "Alleged Failure." The word "alleged" is potent with meaning in this sentence. It is clear that an "alleged failure" is not necessarily an actual failure to charge off sufficient depreciation in the past.

(c) "Actual Value." Here, perhaps, is a term more or less ambiguous, and if there are any words in A. R. M. 106, the use of which was unfortunate, it is in the employment of this expression. Still, any one having a fair conception of the fundamental basis of invested capital, should have never raised the question as to what it means. It could only mean, on the basis of invested capital procedure, cost value less depreciation to date. As a matter of fact, there is no such thing as actual value based on any other hypothesis. Appreciated value may appear clear—actual—but it is not actual. No appreciation is actual value until that value has been realized by a sale or other disposition of the asset.

(d) "Might have been taken." Some corporations, in real fat years, do take depreciation in excess of what is regarded as actual. They do this in order to be ultra-conservative and if the corporations referred to in this Memorandum had desired to guard doubly against lean years of the future and had chosen to charge off depreciation in excess of the presumptive depreciation, there is no question in the world but that they could add back that excess depreciation to invested capital when they had shown by "affirmative evidence" that such depreciation was excessive. Conversely, and we have (e) to consider. If insufficient

depreciation had been charged off and the Unit can furnish "affirmative evidence" that the depreciation charged off was insufficient, then we should reduce invested capital by the insufficiency of depreciation.

It is clear that nothing in A. R. M. 106 prohibits us from adjusting surplus, provided we can furnish the "affirmative evidence" that surplus is not correct, and there is nothing to prohibit corporations from increasing its invested capital to the extent that depreciation charged off in prior years has been excessive, provided that each furnishes "affirmative evidence" that such depreciation was not a reasonably true amount.

To put it in a nut shell, surplus as revealed by the books of account must be assumed to be correct in so far as depreciation or depletion is concerned unless the party, be it a taxpayer or the government, can show by "affirmative evidence" that it is not correct. No arbitrary or dogmatic assertion that it is not correct, by either party, is to be accepted.

For years, I have, in my excess profits classes and in my lectures in the various Field Service and other schools conducted by the Training Section, hammered the point that under no conditions can appreciation of values be included in invested capital under the 1918 tax law. Others have done the same. It has been shouted from the rooftops times without number and yet, even today, some one will come forth with a hypothetical proposition in which he thinks he can show that our teachings have been wrong. One will try to show that it is justifiable by Article 844; another by A. R. M. 106; another by certain computations in the determination of the reduction of invested capital by reason of inadmissible assets carried; another will attempt to show it in some other form. All such ideas are wrong. Invested capital, under the 1918 law is, and never

can be anything in addition to the actual cost of the asset, less depreciation, depletion or obsolescence to date.

There never should have been any question raised as to the basis of invested capital in view of the wording of the law and the regulations and the investigator or auditor is unfortunate if, knowing that he is right in any point, he permits himself to be bluffed out of the stand he takes by any one who is interested in securing reduction of tax liability. When you are right and know you are right, do not allow any influence to move you one iota.

Even though you may have thought, in the past, that the invested capital concept is unconstitutional, it was not within your province to decide to that effect. It is up to the auditor and the investigator to follow the law and the Regulations as found in the Unit's various publications until the highest court in the land decrees that it is not constitutional. But the Supreme Court of the United States in the La Belle Iron Works case has decided for all time that invested capital is based on cost and only upon cost, and while you may have doubted the statement of those in the Unit who have told you this, times without number, it is sincerely hoped that you will accept the decision of the greatest court on earth as deciding the matter once and for all and look upon it as a question not longer debatable, as, in fact, it never was debatable, notwithstanding that it was debated.

It is surprising how often some can be told a fact and still fail to grasp its import. In Bulletin No. 30-21-1748 (page 17) appeared an article entitled "A. R. M. 106 Explained." This explanation told as plainly as words can tell the meaning of "actual value." Either those who receive these bulletins do not read them at all or just scan through them cursorily or they are lacking in comprehension.

It is thought best to give the explanation in its entirety:

A. R. M. 106 EXPLAINED

"Specific inquiry has been made as to the meaning of the words 'actual value' as used in Committee on Appeals and Review Memorandum 106. For the purposes of taxation depreciation is based upon cost. Accordingly the words 'actual value' mean 'sound value,' which is 'original cost' (or value as of March 1, 1913, if applicable), including additions and betterments charged to capital account, less depreciation sustained.

"Article 161, Regulations 45 (1920 edition), defines the proper allowance for depreciation as 'that amount which should be set aside for the taxable year in accordance with a consistent plan by which the aggregate of such amounts for the useful life of the property in the business will suffice, with the salvage value, at the end of such useful life to provide in place of the property its cost, or its value as of March 1, 1913, if acquired by the taxpayer before that date.'

"It follows from this definition that any action on the part of a particular taxpayer which extends the useful life of a depreciable asset beyond the normal or usual term, and any circumstance which serves to increase the salvage value of a depreciable asset, operates to justify a reduction in the normal rate of depreciation. The depreciation of an asset is arrested where it is maintained at a high standard of efficiency either by the exercise of unusual care in its use or by unusual maintenance expenditures.

"Invested capital, as defined in the excess profits tax law, is a statutory concept and is composed of two elements: (a) original contribution, and (b) earnings of the corporation available for distribution but not distributed and not dissipated by subsequent operating losses. The exhaustion of this capital through use, wear and tear has, for the purpose of computing invested capital, the same effect as an operating loss, and unless this loss is properly taken care of out of earnings in one way or another earned surplus must be adjusted in accordance with the provisions of the regulations. There are two ways of taking care of this loss out of income. One is by charging ordinary repairs directly to expense and setting up a depreciation reserve against which are properly chargeable all renewals and replacements; the other is where renewals and replacements, as well as repairs, have been charged directly against gross income. Either way has the effect of reducing the amount added during the year to earned surplus. Consequently, the mere fact that no depreciation, or a minimum depreciation, has been charged as such

is not sufficient reason for reducing the earned surplus where renewals and replacements sufficient to care for the decrease in value of capital assets have been charged directly to expense, or where for any of the other reasons hereinbefore suggested less than the normal rate of depreciation is properly chargeable. When a taxpayer makes this claim there are two methods of verifying it. One is by determining the plant efficiency and the other is by determining the value of the capital assets remaining. From an administrative standpoint the latter is probably more practical even though it may be said that the former is more accurate.

"Many cases have been brought to the attention of the Committee where corporations have been in existence for a long period of years, some of which corporations have been in existence several times the ordinary estimated life of the depreciable assets, and yet those assets are today in first-class condition and worth the figure at which they are carried on the books, although no depreciation has been charged as such and no additions to capital account have been made. In such cases it is obvious that depreciation has been adequately cared for by charges to expense, although it frequently happens that it is impossible at this late date to segregate and specify such charges and there is no warrant in the law or the regulations for requiring the depreciable assets in such cases to be written down below the figure at which they are carried on the books, since to do so is to reduce earned surplus twice, once through the original charge to expense (whether proper or improper) and again through an arbitrary depreciation charge required by the Bureau to be set up against earned surplus for the purpose of computing invested capital.

"The controlling rule in this matter is found in that part of article 839 of Regulations 45, which reads:

"Adjustments in respect of depreciation or depletion in prior years will be made or permitted only upon the basis of affirmative evidence that as at the beginning of the taxable year the amount of depreciation or depletion written off in prior years was insufficient or excessive as the case may be.

"Mere failure in prior years to have written off on the books the maximum or ordinary rate of depreciation is not in itself "affirmative evidence." There is no warrant for reducing earned surplus

because of alleged failure to charge off sufficient depreciation in the past, unless the depreciable assets of the corporation are valued on its books at the beginning of the taxable year at an amount in excess of their sound value at that time."

Apparently the explanation just quoted did not have the effect it should have had and in Bulletin 37-21-1822-T. D. 3220 (page 18) appeared the following over the signature of Commissioner of Internal Revenue, D. H. Blair.

"To collectors of internal revenue and others concerned:

"An examination of income and excess profits tax returns for 1917 and subsequent years has disclosed that many taxpayers have used appreciated and inflated values in determining invested capital shown in such returns contrary to section 207 of the Revenue Act of 1917 and section 326 of the Revenue Act of 1918.

"This office has held consistently that the use of appreciated or inflated values in determining invested capital is not permissible and this ruling has been sustained by the United States Supreme Court in the case of the La Belle Iron Works v. The United States (41 Sup. Ct., 528; T. D. 3051).

"All taxpayers who, in the preparation of their income and excess profits tax returns for 1917 and subsequent years, have used appreciated or inflated values in determining the amount of their invested capital are required to file with the collector of internal revenue within 90 days from date of this decision amended returns for each of such years, in which the invested capital shall be computed strictly in accordance with the law and regulations and without the use of appreciated or inflated values. It is not required that such amended returns shall include the figures shown in the original returns which are unaffected by this decision. Only such figures as are necessary to show the correct values used in the computation of invested capital and such totals as are necessary to a redetermination of the tax need be shown. Payment of the additional tax shown to be due on such amended returns must also be made at the time the returns are filed.

"Failure to file amended returns within the time specified will subject taxpayers to the penalties provided for in section 3176, United States Revised Statutes, as amended."

In a still further effort to make clear a matter that should have been as clear as day with the statements and explanations already made by the Bureau, there appeared in Bulletin 46-21-1926-O. D. 1104 (page 12) an office decision over the signature of Commissioner Blair, as follows:

SECTION 326.—INVESTED CAPITAL

“Section 326, Article 839: Surplus and undivided profits: allowance for depletion and depreciation.

“Reference is made to Committee on Appeals and Review Memorandum 106 (C. B. 4, p. 390) and explanatory memorandum of the Committee dated July 6, 1921 (Bul. 30-31, p. 17).

“The attention of the Commissioner’s office has been called to the fact that article 839 of Regulations 45 as interpreted by Committee Memorandum 106 and the memorandum of July 6th has not been properly followed.

“When the Regulation (Art. 839 of Reg. 45) was being drafted it was the intention of the draftsmen that a corporate surplus account was not to be disturbed lightly and that no change should be made in it either by the Government or by the taxpayer except upon adequate evidence that the surplus account was incorrect. It was the view of the draftsmen that unless the taxpayer could show a state of error the Government should deny a claim for an increase in the surplus shown by the taxpayer’s books; conversely, before a deduction could be made from the taxpayer’s surplus account, the Government must show that such an adjustment is necessary to correct the account. The view was also held that such proof must be in the form of affirmative evidence; that it could not rest upon mere assertion or the working out of the theoretical formula.

“It is my opinion that no doubt ever should have existed as to the correct interpretation of article 839. A taxpayer’s corporate surplus should not be reduced by the arbitrary adjustment of depreciation and depletion for past years. Surplus accounts should, however, always be carefully scrutinized and checked up for the purpose of preventing the inclusion therein of appreciated values of property. In case of doubt in such case the burden should be cast upon the taxpayer to prove that no appreciated values were included in the

surplus. A presumption should always exist that a taxpayer's books of account reflect actual facts. The burden of proof is upon any one who attempts to impugn the correctness of the books of account—upon the Government if it seeks to reduce its surplus account by charging off depreciation and depletion which have not been claimed by the taxpayer and upon the taxpayer where he claims that too much depreciation and depletion have been charged off in prior years."

In view of what has been given in this chapter and quotations which have been made from official publications, it would appear to be futile to add anything further. If there be any in the Unit who are not now able to appreciate the full significance of A. R. M. 106 (as well as its limitations) volumes written on the subject would avail not.

CHAPTER THIRTEEN

RESUME—A TYPICAL CASE

The 1918 income tax return of the Crescent Manufacturing Company was accompanied by Balance Sheets, copies of which are presented on pages 240 and 241.

Also, the following information was submitted:

1. The corporation was organized January 2, 1909, with an authorized Capital Stock of \$300,000, all common. Of this amount \$100,000 was issued at par, for cash, at the time of organization. At January 2, 1916, additional shares numbering 1,820 were issued at par value, 500 of which shares were issued for the tangible assets of the Sherwood Malleable Iron Works, and 1,000 shares were issued for the Goodwill of said Works. The Sherwood Company, shortly before this transaction, had been offered \$125,000 cash for this Goodwill, but since the parties making the offer did not care to take over the tangible assets, the deal could not be consummated. The par value of all shares is \$100. (For obvious reasons, all names given in this case are fictitious.)

2. The corporation reported a net taxable income for 1918 equal to the difference between the amount of undivided profits as at the beginning of the year and as at the end of the year, plus the Red Cross donation, plus the Federal Income Taxes paid in 1918 for 1917, amounting to \$70,000, or a total income of \$126,000.

A number of items appeared to be questionable, and Agent Frank P. Hadley was instructed to make an exam-

ination of the books of the concern and to submit a detailed report.

The facts as ascertained by Hadley, in so far as they relate to this problem, are given in the following pages, beginning on page 242.

Hadley computed the invested capital to be \$529,396.58. Do you agree with him? If not, can you locate the error?

He stated that the net taxable income for 1918 amounted to \$158,500. What is your conclusion?

ORIGINAL BALANCE SHEETS

<i>Current Assets:</i>	Dec. 31, 1917	Dec. 31, 1918	
Cash	\$20,000	\$38,000	
Accounts Receivable	40,000	67,000	
Notes Receivable.....	18,000	33,000	\$138,000
<i>Inventory Assets:</i>			
Raw Material	123,000	138,000	
Partly Finished Goods...	42,000	60,000	
Finished Goods.....	70,000	76,000	274,000
<i>Fixed Assets:</i>			
Machinery	45,000	60,000	
Miscellaneous Equipment	6,000	8,000	
Furniture and Fixtures..	2,000	2,000	
Buildings	60,000	\$60,000	
Less Depreciation.....		10,000	50,000
Switching Facilities.....		2,000	
Land	110,000	75,000	197,000
<i>Patent Assets:</i>			
Groups A. B. & C.	58,000		89,000
<i>Deferred Assets:</i>			
Prepaid Advertising	8,000		7,000
Prepaid Salaries.....	4,000	12,000	
<i>Sinking Fund Assets:</i>	60,000		80,000

Securities:

Railroad Stocks.....	100,000		50,000	
Railroad Bonds.....	10,000		60,000	
State of Ohio Bonds....	20,000			
Liberty Bonds (4%)....	5,000		5,000	
Harmon Corp. Bonds....	27,000		27,000	
City of Buffalo Bonds...	5,000		5,000	
Foreign Corp. Stock....	25,000		15,000	
Federal Res. Bank Stock	8,000		8,000	
War Finance Corp. Bonds	5,000	205,000		-170,000

Other Assets:

Employees' Stock Sub-				
scriptions.....	18,000		10,000	
Treasury Stock.....	27,000		18,000	
Chemical Formula.....			6,000	
Goodwill	100,000	145,000	100,000	134,000
		<u>\$1,016,000</u>		<u>\$1,089,000</u>

ORIGINAL BALANCE SHEETS

<i>Current Liabilities:</i>	Dec. 31, 1917	Dec. 31, 1918		
Accounts Payable.....	\$65,000	\$33,000		
Notes Payable (secured)....	24,000	22,000		
Notes Payable (unsecured)..	10,000	15,000		
Interest on Mortgage.....	1,500	1,500	\$100,500	\$71,500
<i>Fixed Liabilities:</i>				
20-year Debenture Bonds....	200,000	200,000		
Mortgage on Realty.....	25,000	25,000	225,000	225,000
<i>Reserves:</i>				
For Lighting System.....	24,000	30,000		
For Switching Facilities....	19,500	17,500		
For Development of Patents,				
Group A.....	35,000	4,000		
For Bad Debts.....	2,000	5,000		
For Federal Income Tax....	65,000	85,000		
For Bond Redemption.....	60,000	80,000		
For Plant Extension.....			205,500	35,000
<i>Capital, Surplus, Etc.:</i>				
Capital Stock Authorized....	300,000	300,000		
Surplus	75,000	75,000		
Undivided Profits.....	110,000	485,000	161,000	536,000
Total Liabilities and Capital.....	<u>\$1,016,000</u>	<u>\$1,089,000</u>		

Note: All increases and decreases in Reserves are reflected in Undivided Profits Account.

Part of Hadley's Report

All of the report submitted by Agent Hadley is not given in the following pages, but only such portions as are pertinent to the problem in hand; that is, the determination of invested capital for 1918, and the amount of taxable income for the same period. The following are selections from the report:

1. No dividends were paid by the corporation during 1918.

2. Donations were as follows: Red Cross, \$5,000; Y. M. C. A., \$3,000; Salvation Army, \$2,000; total donations, \$10,000.

The first of these was charged to Expense, the second to Undivided Profits, and the third to Undivided Profits on December 31, 1918, after the closing of the books.

3. The buildings were completed January, 1916, and had an estimated life period of fifty years.

4. Furniture and Fixtures were purchased July 1, 1917, and are subject to the usual wear and tear.

5. The Machinery should last for fifteen years, and the Miscellaneous Equipment should last for twenty years, after purchase. At date of organization, \$30,000 of machinery was purchased and \$3,000 worth of Miscellaneous Equipment; January 2, 1916, machinery amounting to \$15,000 and Miscellaneous Equipment amounting to \$3,000 were purchased. January 2, 1918, the remainder of the machinery was purchased, and at July 1, 1918, additional Miscellaneous Equipment was purchased, amounting to \$2,000.

6. Patents, Group A was purchased with stock issued

at par. It is well established that this group would be grabbed up by a competitor of the corporation at an amount greater than the amount at which all patents are carried, and that it would pay cash for the group. Twenty-two thousand dollars of stock was issued for it.

Group B was purchased for cash, \$20,000.

Group C was received by the corporation during 1917, in exchange for some inadmissibles that the corporation held at that time.

In 1917 the corporation carried another patent group, known as Group D. December 20, 1917, this group was exchanged for War Finance Corporation Bonds in the amount of \$10,000.

7. On the books of the corporation was found the item, "Interest paid to carry inadmissibles, \$1,500." Of this amount \$500 was for money borrowed to carry Buffalo City Bonds and the Harmon Corporation Bonds, half-and-half. The balance, or \$1,000, was for money borrowed to carry railroad stocks. The Agent recommended that this item be disallowed as expense, and that net income be increased by \$1,500. See Article 121.

(If you should determine that a part, or all, of this interest should be disallowed as a deduction, and if your conclusion be correct, a certain amount of inadmissibles should be deemed admissible to be in conformity with Article 817, (b). For the present we shall ignore this phase of the question. There seems to be difference of opinion as to how it should be solved. Further, we should not have known that the corporation borrowed this money for this particular purpose except for the fact that the Treasurer happened to be the man that Diogenes missed.)

8. Of the railroad stocks, \$50,000 were sold July 15, 1918, for \$55,000, which amount included accrued but unpaid dividends amounting to \$3,000. Of the proceeds of

the sale, \$50,000 were at once reinvested in railroad bonds. The \$5,000 was included in income.

9. The foreign corporation stock items were as follows:

Liverpool Cotton Mills, \$10,000. This corporation receives no income from sources within the United States.

Bristol Valve and Gear Company, \$15,000. This concern has a Branch in the United States and its goods are handled quite generally by jobbers in mill supplies throughout the United States. During 1917 and 1918, owing to the war, this company did business at a loss, hence no dividends were declared for those years.

The \$10,000 block of Cotton Mills stock was sold July 2, 1918, at a profit of \$1,000. Dividends received on this stock, \$800. These amounts, total \$1,800, were included in the taxpayer's report of income.

10. The state of Ohio bonds were sold at cost, September 10, 1918.

11. It was found that Robert Green, one of the stockholders and a director of the corporation, purchased stock January 2, 1916, to the amount of \$32,000. To make the purchase he borrowed \$22,500 at 6% interest. The interest has been paid promptly, but none of the original borrowings has been paid, except one amount of \$5,000. To procure this money Green found it necessary to borrow it from the corporation, and gave his interest-bearing note at two years from September 10, 1917, without security. Bradstreet does not give Green a rating, and states "Slow pay."

12. The agent states that he made a careful examination of all entries and that the only items to which he can take exception are: sufficient depreciation was not charged

off and he recommends that Prepaid Advertising and Salaries Advanced be charged to Expense. ' Also, he found that Salaries Advanced Account had a debit balance of \$1,000 at the end of the year.

13. No interest was received on the Railroad Bonds and the corporation claimed that failure to receive any such interest from these holdings justified it in including the bonds as admissible assets. (See Article 815.) In your solution, be careful to state specifically what conclusion you arrive at with reference to the legality of this matter and give specific reasons for your conclusion.

14. The \$30,000, par value, Treasury Stock held at December 31, 1917, was purchased at \$90 a share, July 2, 1917. August 2, 1918, \$10,000 par value, of this stock was sold at \$110 a share. The difference between the price the corporation paid for the stock and the selling price was included in Undivided Profits as at December 31, 1918.

(In this connection, you should note that the stock was originally sold at par value. It was re-acquired at near par value, and can in no sense be construed as having been acquired as a gift or "at a price substantially less than par," hence the so-called "double deduction" does not enter in. Note, also, that the corporation carried the stock at cost; in other words, the book value differs from par value.)

15. The remainder of the unissued stock, 180 shares, was sold to employees December 30, 1917, under a contract by which a percentage of the salaries was to be taken out each month in payment for the stock, which actually was issued to the employees. The amount payable each month was \$800.

The matter of withholding these amounts on pay days was overlooked until November 2, 1918, at which time it was found that \$8,000 was due. The employees at that date

paid \$5,000 of the amount due in cash, and the balance, \$3,000 was paid in notes, drawing interest, in face of the fact that the laws of the state under which the charter was granted forbid the acceptance of notes for stock. There is not the least question but that the notes are collectible and are worth face value at the bank. The November and December payments were made January 5, 1918 (prior to filing return for 1918).

16. The land consisted of four adjoining and similar lots. During the year two lots were sold for \$75,000 cash. The value of the four lots as at March 1, 1913, was \$150,000, but no change was made in the book values, which always had been the same as cost—\$110,000. After the sale, however, the company could not see any reason why its books should not reflect actual worth and the book value of the remaining two lots was raised to sale value—\$75,000. Since invested capital is almost wholly based on the balance sheet as at the beginning of the year, it was felt that this action would make no difference in the amount of taxes due the government for 1918.

17. The formula was acquired September 13, 1918, being paid for with War Finance Corporation Bonds in the amount of \$5,000.

18. During the year the work of surveying for the railroad switches was done, and some other work was done at grading, amounting, all told, to \$2,000.

Of the amount in reserve for the development of patents, \$31,000 was expended on group A.

For several years the corporation has been building up a Reserve for Lighting Plant. At the end of the taxable year \$6,000 was added to this account, and charged to Surplus. (This account is purely Allocated Surplus.)

19. Receivables to the amount of \$3,175.40 were found to be uncollectible and charged to P. and L.

20. For reasons of its own the corporation makes a practice of holding Surplus Account at a given figure, always showing, on the balance sheet, under Undivided Profits, the fluctuations in net worth.

21. In the Agent's report he frankly admitted that he was at a loss to know what to do with the Debenture Bonds, and, as is sometimes done, he left it up to the Unit to make a decision. He computed two invested capital amounts, and taxes based on the two figures, one amount of invested capital named by him was about \$200,000 less than the other. The amount named on page 240 does not include Debenture Bonds.

The bonds were issued at 3%, January 2, 1916, and only to stockholders, and paid for in cash at face value. It is stipulated that the interest shall be paid semi-annually, but no interest has ever been paid. Each year Accounts Payable is credited with \$6,000 and Interest Expense is debited a like amount. Another thing to consider in this connection is that on December 31, 1918, by resolution of the board of directors, it was decided to make application early in January, 1919, for the privilege of increasing Capital stock to \$500,000, the several stockholders to surrender all bonds for an equal amount of the new issue of stock, for, as they view the matter, the bonds are capital stock in all respects except in name. Of course, when this is done, Bond Redemption Reserve Account will be charged with \$80,000 and Surplus will be credited with a like amount. Capital Stock account will be credited with \$200,000 and the Debenture Bond liability account will be charged with \$200,000.

STOP RIGHT HERE—NOW.

Would you deliberately cheat yourself?

If you are willing to treat yourself fairly show it now

by abstaining from looking at any of the pages that follow this page until you have worked the problem just presented, and have found answers to these three questions:

1. What is the invested capital of this corporation?
2. What is the taxable income of this corporation?
3. On the basis of the amended balance sheets as at December 31, 1918, how much goodwill would you allow this corporation for the year 1919?

The pages that follow this page contain a complete solution to the problem, but if you have studied carefully the five preceding chapters, you will not need the solution to aid you. Not a question can come up in this problem that has not been covered in those chapters—somewhere.

Solve the problem by your own efforts and the aid of the preceding Chapters. Then compare your solution with the one given in the following pages. **DO NOT** solve one thing at a time and then refer to the official solution to see if you are right as far as you have gone. **CLIP THE FOLLOWING PAGES TOGETHER**, and do not withdraw the clip until such time as you have determined upon the answers to the three questions given above. **BE HONEST WITH YOURSELF.**

CHAPTER FOURTEEN

SOLUTION TO CHAPTER THIRTEEN

In terming this problem a typical case, it is not intended to convey the impression that all things have been fully explained in the agent's report down to minute details, or even in some things of greater moment. Had such a course been followed it certainly would have little attraction for the worker who desires to "dig things out." The only persons worth while are those who try to do just that—dig things out. For others no problem could be sufficiently set forth to meet their desires—perhaps their needs. The ambitious man wishes to discover for himself, so far as possible. The indolent and all-wise inefficient want to be told, and we have not sufficient time for that.

Had all things been made perfectly clear in the problem it would have ceased to be a problem and would have become merely a monograph of instruction that would have defeated its very purpose—the bringing out what *you* have learned from the previous chapters of the series, each of which may properly be called a monograph on, or an epitome of one phase of invested capital.

Further, had all things been made clear, it could not be called a typical case, for no typical case has ever been audited that did not leave some things to *judgment*, reason, discrimination, or *penetrativeness*. The auditor without such qualifications is at the wrong job—a round peg in a square hole.

To illustrate: A glance at the Balance Sheet as presented reveals the fact that the corporation is carrying

more goodwill (which, of course, may include patents) than is justifiable by the statements made. It is stated that \$100,000 stock was issued for the Goodwill of the Sherwood Works, and later it is shown that Stock was issued for a patent. The auditor with a penetrating mind and a fair acquaintance with the law (state laws) as applied to corporations would discover that a patent or patents must have been embraced in the \$100,000 Goodwill, for the total stock issue *could not possibly* exceed \$300,000, and the issue of the entire 3,000 shares was fully accounted for. It should be quite patent that a concern as large as this would not deliberately issue more stock than was authorized by its charter.

Likewise, the adjustments to Treasury Stock values, prepaid salaries, real estate values and profits, formula value, and other things might have been more fully explained, only to "kill" the intent of the problem. This problem was constructed for the benefit of those who *think* and think *deeply*. The superficial are wasting their time in considering it at all.

There are two good methods of computing invested capital. The way that it is presumed to be done by the taxpayer is for him to fill out the various schedules in form 1120, making the necessary adjustments in Schedule E to L, inclusive, and to summarize the whole under schedule II.

This is the method that is followed by a good many auditors, but since they do not have an unlimited supply of blanks of form 1120 it is necessary to resort to the making of dummy forms, which entails unnecessary work.

If the balance sheets submitted by the taxpayer evidence "substantial changes during the taxable year" in the amount of inadmissibles carried, an adjusted balance sheet must be set up. In this connection it is fitting to

remark that all changes in the inadmissibles in the problem in hand, are, for illustrative purposes, regarded as "substantial."

The second method is to set up new balance sheets, entering each item at its *invested-capital* value. The invested capital will then be the stock outstanding, *plus* surplus allocations, and the pro-rated amount of stock sold during the year, LESS any reduction that may have taken place by reason of income tax paid, dividend distribution, treasury stock bought, or stock retired—all pro-rated over the period.

The second method deals only with the balance sheet and is complete within itself; entirely free from schedules. The first-named method, in the event of substantial changes in inadmissibles, requires the setting up of the amended balance sheets in addition to working out the several schedules.

It is the opinion of the writer that the second method is much the simpler, less liable to error, and from the viewpoint of accounting technique, more logical.

But, since opinions differ, and the fact that some will prefer the first; and others the second method, both will be presented in this solution.

In the solution following, only such schedules will be shown as enter into this problem, and the line numbers will conform to form 1120 (1918), without giving the explanatory matter given opposite each line in the form. It may be good practice to fill out a blank form from the figures here given. There seem to be several variants of this form, especially as regards schedule E, and for that reason the copy you may fill out may not harmonize exactly with the line numbers we shall here use.

Schedule E

Line 3.....	\$282,000
Line 4.....	\$282,000
Line 6.....	390,500
Line 8.....	\$672,500
Line 9.....	27,000
Line 10.....	<u>\$645,500</u>

(The writer has seen three variations of line 9. In one, it was numbered 10, in one it did not appear at all.)

Schedule G

Line 1.....	\$59,000
Line 6.....	24,150
Line 9.....	<u>\$83,150</u>

Schedule H

Line 1. Treasury Stock....	Aug. 2/18 10	\$110.	\$11,000	152	\$4,580.82
Line 2. Stock issued to					
employees	Nov. 2/18 50	100.	5,000	60	821.92
					<u>\$5,402.74</u>

(Red ink entry)

1917 income tax paid.....	\$70,000	200	38,356.16
Less stock additions as lines 1 and 2.....			5,402.74
Net reduction.....			<u>\$32,953.42</u>

Schedule II—Invested Capital

Line 1.....	\$645,500.00
Line 3.....	\$645,500.00
Line 4.....	83,150.00
Line 5.....	\$562,350.00
Line 6.....	32,953.42
Line 7.....	<u>\$529,396.58</u>

Line 7 would indicate the invested capital had there been no inadmissibles carried. To arrive at the amount of deduction made necessary on account of inadmissibles, we *must* set up a new balance sheet, adjusted in accordance with income-tax procedure. From now on we shall present the *second* method of arriving at invested capital, beginning with the amended balance sheets on the next page. Regardless of the method employed in arriving at invested capital, it is necessary to ascertain the average of the balance sheets as at the beginning and as at the end of the taxable period. The sale of inadmissibles during the period is likely to make this a tedious process.

AMENDED BALANCE SHEETS

ASSETS

<i>Current Assets:</i>	<i>Dec. 31, 1917</i>		<i>Dec. 31, 1918</i>	
Cash	\$20,000		\$38,000	
Accounts Receivable..	40,000		67,000	
Notes Receivable.....	18,000	\$78,000	30,000	\$135,000
<i>Inventories:</i>				
Raw Material.....	123,000		138,000	
Partly Finished Goods	42,000		60,000	
Finished Goods.....	70,000	235,000	76,000	274,000
<i>Fixed Assets:</i>				
Machinery ...	\$45,000		\$60,000	
Less Depre-				
ciation ...	20,000	25,000	24,000	36,000
Miscellaneous				
Equipment .	6,000		8,000	
Less Depre-				
ciation ...	1,650	4,350	2,000	6,000
Furniture and				
Fixtures ...	2,000		2,000	
Less Depre-				
ciation ...	100	1,900	300	1,700

Buildings	60,000		60,000	
Less Depre-				
ciation ..	2,400	57,600	3,600	56,400
Railroad				
Facilities			2,000	
Land	110,000	198,850	55,000	157,100
<i>Deferred Assets:</i>				
Prepaid Advertising	8,000		7,000	
Salaries Advanced...	4,000	12,000	1,000	8,000
<i>Patent Assets:</i>				
Group A.....	22,000		53,000	
Group B.....	20,000		20,000	
Group C.....	16,000	58,000	16,000	89,000
<i>Sinking Fund Assets:</i>		60,000		80,000
<i>Securities:</i>				
Railroad Stocks.....	100,000		50,000	
Railroad Bonds.....	10,000		60,000	
State of Ohio Bonds..	20,000			
Liberty Bonds (4%) ..	5,000		5,000	
Harmon Corporation				
Bonds	27,000		27,000	
City of Buffalo Bonds.	5,000		5,000	
Foreign Cor. Stock				
(inadmissible)	15,000		15,000	
Foreign Cor. Stock				
(admissible)	10,000			
Federal Reserve Bank				
Stock	8,000		8,000	
War Finance Corpora-				
tion Bonds.....	5,000	205,000		170,000
<i>Other Assets:</i>				
Chemical Formula....			5,000	
Goodwill	\$63,000		63,000	
Less Pat-				
ents A.....	22,000	41,000	22,000	41,000
		\$887,850		\$959,100

LIABILITIES

<i>Current Liabilities:</i>		<i>Dec. 31, 1917</i>	<i>Dec. 31, 1918</i>	
Accounts Payable.....	\$65,000		\$33,000	
Notes Payable.....	34,000		37,000	
Interest on Mortgage.....	1,500	\$100,500	1,500	\$71,500
		<hr/>	<hr/>	
<i>Fixed Liabilities:</i>				
20-year Debenture Bonds.....	200,000		200,000	
Mortgage on Realty.....	25,000	225,000	25,000	225,000
		<hr/>	<hr/>	
<i>Reserves:</i>				
For Lighting System.....	24,000		30,000	
For Railroad Facilities.....	19,500		17,500	
For Development of Patents, Group A	35,000		4,000	
For Bad Debts	2,000		5,000	
For Federal Income Tax.....	65,000		85,000	
For Bond Redemption.....	60,000		80,000	
For Plant Extension.....		205,500	35,000	256,500
		<hr/>	<hr/>	
<i>Capital and Surplus:</i>				
Capital Stock Outstanding...	252,000		267,000	
Surplus and Undivided Profits.	104,850	356,850	139,100	406,100
		<hr/>	<hr/>	
		\$887,850		\$959,100
		<hr/>		<hr/>

Arriving at Invested Capital

Stock outstanding at beginning of the year.....	\$252,000.00	
Surplus and Undivided Profits.....	104,850.00	
Surplus Allocations (true Reserves).....	205,500.00	
		<hr/>
Invested Capital Basis.....	\$562,350.00	
Plus: Treasury Stock sold August 2, 1918—		
152/365x\$11,000=	\$4,580.82	
Employees' Stock paid No. 2—		
60/365x\$5,000=	821.92	5,402.74
		<hr/>
		\$567,752.74
Less: Income tax paid June 15, 1918—		
200/365x\$70,000=		38,356.16
		<hr/>
		\$529,396.58
		<hr/>

The amount given at the bottom of the previous page is the same as the amount stated in Line 7, Schedule II. This must be reduced by a certain percentage, which percentage is arrived at by dividing the *averaged* amount of inadmissibles held throughout the year by the total admissible assets *and* inadmissible assets, *averaged* throughout the year.

See Paragraph 8, page 243 (Railroad Stocks—Bonds).

Profit on sale.....	\$2,000	
Other income.....	3,000	Profit is to total income
	<hr/>	as 2 is to 5, or 2/5
Total income.....	\$5,000	

2/5 of \$100,000 is \$40,000, the amount that becomes admissible up to date of the sale—195 days.

	195/365x\$40,000 = (admissible)	\$21,369.86
Receipts; \$55,000, admissible for remainder of year—170 days.		
	170/365x\$55,000 = (admissible)	25,616.44
		<hr/>
	Total admissible.....	\$46,986.30

Total, \$100,000, less restoration, 40,000, leaves \$60,000 inadmissible. Of this amount \$50,000 remained constant throughout the year, and \$10,000 was inadmissible up to the date of the sale—195 days—

195/365x\$10,000 = (inadmissible)	5,342.46+
Constant inadmissibles.....	50,000.00

Total average of this asset (including bonds bought) ... \$102,328.76+

Proof of Computation

It will be noted that \$5,000 came in on July 15 and that this amount was included in the averaging process, hence, if we pro-rate the \$5,000 for the period it was in

the business and deduct the pro-rated average from the total given above, we should arrive at the original holdings—\$100,000.

$$170/365 \times \$5,000 = \$2,328.767$$

Deducting \$2,328.767 from \$102,328.76+ leaves the original amount of stock held—\$100,000. Had this stock been sold at a profit, with no other income from this source, the entire \$100,000 would become admissible for the year. See Paragraph 10 (State of Ohio Bonds).

This inadmissible was carried by the corporation for a period of 252 days—

$$252/365 \times \$20,000 = (\text{average inadmissible}) \$13,808.22$$

The proceeds of the sale were not reinvested in inadmissibles, hence they are admissible for the remainder of the period—

$$113/365 \times \$20,000 = (\text{average admissible}) \text{ -- } 6,191.78$$

$$\text{Total holdings} \text{-----} \$20,000.00$$

See Paragraph 17 (Formula).

Inasmuch as the Formula was paid for with the equivalent of cash, it must be allowed reflection in Surplus at the amount paid for it. The fact that it was purchased with an inadmissible, does not require that it be classed as an inadmissible.

The proceeds of the sale (it is the equivalent of a sale) become admissible for the remainder of the period, or 110 days—

$$110/365 \times \$5,000 = (\text{average admissible}) \text{ ----} \$1,506.85$$

The asset was inadmissible for a period of 255 days—

$$255/365 \times \$5,000 = (\text{average inadmissible}) \text{ --} \$3,493.15$$

Averaging the Balance Sheet (see page 191, Chapter Ten).

<i>Item</i>	<i>Admissible</i>	<i>Inadmissible</i>
Railroad Stocks—restored.....	\$21,369.86	
Total receipts.....	25,616.44	
Average of unrestored.....		\$5,342.46
Constant portion.....		50,000.00
State of Ohio Bonds.....	6,191.78	13,808.22
War Finance Corporation Bonds.....	1,506.85	3,493.15
	<hr/>	<hr/>
Totals of averaged amounts.....	\$54,684.93	\$72,643.83
To the above averaged inadmissible amount must be added the inadmissibles that were constant during the period—		
City of Buffalo Bonds.....	\$5,000.00	
Foreign Corporation Stock.....	15,000.00	
Federal Reserve Bank Stock.....	8,000.00	28,000.00
	<hr/>	<hr/>
Total averaged inadmissibles for the year.....		\$100,643.83
Footings of Adjusted Balance Sheets as given	12-31-17	12-31-18
on page 254.....	\$887,850.00	\$959,100.00
Less the totals of the averaged items given above; that is, \$54,684.93 plus \$100,643.83...	155,328.76	155,328.76
	<hr/>	<hr/>
	\$737,521.24	\$803,771.24
Added and Averaged.....	803,771.24	
	<hr/>	
	2) \$1,536,292.48	
	<hr/>	
	\$768,146.24	
This is the average of all assets not previously consid- ered. To get the true average of <i>all</i> assets held throughout the period there must be added to this amount the amount of deduction above—		
The above averaged amount.....	\$768,146.24	
The averaged admissibles.....	54,684.93	
The average inadmissibles.....	100,643.83	
	<hr/>	
Average of the total assets.....	\$923,475.00	
Proof		
Balance Sheet at beginning of year.....	\$887,850.00	
Balance Sheet at the end of year.....	959,100.00	
	<hr/>	
	2) \$1,846,950.00	
	<hr/>	
General Average.....	\$923,475.00	

The net amount of invested capital may be obtained by the use of the following formula:

$$\$529,396.58 - \left(\frac{\$100,643.83}{923,475.00} \times \$529,396.58 \right) = \$471,700.92$$

Schedule II form 1120 may now be completed:

Line 7 (brought forward from page 255)...	\$529,396.58
Line 8	57,695.66
Line 9 (net invested capital).....	<u>\$471,700.92</u>

Comment on the Agent's Report: (The paragraph numbers refer to the paragraphs in the problem).

While it may be unusual for a corporation to hold Federal Reserve Bank Stock, still it is a legal possibility with certain limitations and the apparent stipulation that the holdings of an individual or corporation may not exceed \$25,000. Hence, to the well-informed, this item will not be questionable.

2. The charge to Undivided Profits, *after* the closing of the books for the period would not affect 1918 income, so far as tax is concerned. It would reduce invested capital for the *next* period.

The other donation charged to Undivided Profits does affect the taxable income. Had the charge not been made, the Undivided Profits account would be larger by the amount of the donation, and since we are to arrive at the net income for the period from a study of the balance sheet, we must include this \$3,000 donation.

6. It matters not what a patent may be worth, or what some one is willing to pay for it. What it *cost* the

corporation is the only factor to be considered in computing invested capital.

Group B, being purchased for cash, does not come within the 25% limitation. It is still a form of goodwill, but it is allowable to the full amount of cash paid for it.

Group C was paid for in inadmissibles. It is to be presumed, of course, that the inadmissibles were worth \$16,000, hence they are the equivalent of cash. An asset acquired in exchange for an inadmissible is not treated as inadmissible unless it is, ipso facto, inadmissible.

7. Interest appears to have been paid as follows:

Buffalo City Bonds.....	\$250
Harmon Corporation Bonds.....	250
Railroad Stock.....	1,000

The only unallowable item of interest is the interest paid on the Buffalo (municipal) City Bonds. Interest *received* on the Harmon Corporation Bonds is taxable, therefore, interest *paid* to carry such bonds is an allowable deduction. All income from *industrial* bonds is taxable.

Note that Article 121 states: "But interest on indebtedness incurred or continued to purchase or carry securities, such as municipal bonds, the *INTEREST* upon which * * * ." *Dividends* received are not mentioned—only *interest*, therefore, interest paid on money used to carry or purchase *stocks* is deductible. But, notwithstanding all that, stocks are *inadmissible*. See Article 815.

8. Railroad stocks are inadmissible. Railroad bonds, being industrials, are admissible.

9. Stock held by a domestic corporation in a foreign corporation deriving no income from sources within the United States is admissible. If income be derived from sources within the United States, the stock is inadmissible.

11. It matters not how Robert Green procured the money with which to purchase the stock. The corporation received payment for the stock issued to him and that is all that concerns us. That, later, he borrowed some money from the corporation with which to pay one of his debts, while it may be unusual, it has no effect on invested capital. Not, at any rate, until such time as the account may be found to be worthless and is charged off the books along with other Bad Debts.

12. Liberty Bonds are admissible assets.

13. One can scarcely blame the corporation if it formed the opinion that its Railroad Bonds would have been inadmissible if income on them had been received. In one of the audit sections it was the practice for months to classify industrials as inadmissibles and the change to the correct procedure was made at the instance of the writer of this book. Article 815 might have been stated a little more clearly.

14. The profit made on the sale of Treasury Stock is not taxable. See Articles 542 and 862.

15. Inasmuch as the jurisdiction under which the charter of this corporation was granted did not confer the right to take notes in payment of stock, it certainly had no right to sell stock on open account. But whether or not it might have stretched its privileges, it makes no difference here for unpaid-for stock may not be included in invested capital. We should not include in invested capital the \$3,000 paid for in notes, for the corporation had no legal right to accept the notes. A corporation may not be given the benefit of invested capital which is the result of an illegal act on its part.

16. For invested capital purposes the *cost* of the land is the only element to be considered. Inasmuch as the

sale price was the same as the value as at March 1, 1913, no profit accrues for tax purposes.

Had this item been a *depreciable* asset, having an *established value* at March 1, 1913, greater than the cost, the value at March 1, 1913, would be the depreciation basis in arriving at net income, but it would *not* be the depreciation basis in computing invested capital. See Article 844.

17. It appears that the corporation paid but \$5,000 for the formula and carried it on its books at \$6,000. While it may have been worth \$6,000, or much more, we can allow only the cost price.

In this connection it is interesting to note that if we allowed the \$6,000 value to stand as the value of the formula, and the \$75,000 value on the land, that the profits tax of the corporation would be slightly less than it otherwise would be, due to the fact that a greater average asset value would result, which would have the effect of reducing the percentage of deduction for inadmissibles carried. Had no inadmissibles been carried, the values at which the assets are carried at the *end* of the period would have no effect on invested capital for the taxable year, for, in such case, we are interested only in the values at the *beginning* of the period.

18. The reduction of the reserves for patent and switching facilities, brought about by a charge to the reserves when the assets are being developed, has no effect on invested capital. The only effect is to reduce the value of some asset and a corresponding increase in the value of the assets under development. The amount that the reserves are reduced by the development process is reflected by an equal increase in surplus. The operation is precisely analogous to taking money out of one of your pockets and placing it in another of your pockets.

19. Since it was stated that the agent could find only

certain errors or thought-to-be-errors in the books of the corporation, it must be presumed that this item was rightly charged to Profit and Loss during the period.

20. Do not allow the account, Surplus, to deceive you. Always bear in mind that *true reserves*, undivided profits, and surplus represent the same thing under different names; that the combined amount of these items is the "excess of assets over the total of liabilities and capital." To illustrate by abridged balance sheets—liabilities side:

	Dec. 31, 1917	Dec. 31, 1918
Capital Stock.....	\$20,000	\$30,000
True Reserves.....	4,000	13,000
Surplus	16,000	12,000
Undivided Profits.....	5,000	10,000
	<hr/>	<hr/>
	\$45,000	\$65,000
	<hr/>	<hr/>

Actual surplus at the beginning of the year, \$25,000; at the end of the year, \$35,000. Assuming that no dividends or tax was paid, or other, similar, distribution was made during the year, the profit for the year is the difference between these two figures—\$10,000, and *not* the difference between the amounts of undivided profits.

21. The Debenture Bonds are borrowed capital. The fact that interest has not been paid has no bearing, and is, doubtless, in harmony with the wishes of *all* bondholders. If any of them demanded the interest, and the corporation refused to pay it, the bondholders making the demand could enter suit and recover the amount due, just the same as any other creditor could do if he wished to collect an amount due him. The fact that the bonds were issued under the stipulation that interest was to be paid at certain times, made it mandatory upon the corporation so to pay. Or,

to put it another way, the fact that it was *not* stipulated that the interest be payable only upon a favorable vote of the board of directors, and that it was *not* stated that the interest should *not* be cumulative, places the holders of the bonds on a par with other creditors.

Failure of the corporation to live up to its obligations does not change the status of the bonds in the least. That the bondholders were the stockholders is only incidental. At any day some of the bonds might go into the hands of persons who are not stockholders.

Net Income

We may arrive at net income either by taking the profit for the period as shown by the original balance sheets and making the necessary adjustments by adding to or taking from that amount, or, we may determine it by taking the difference between the Surplus accounts as shown on the amended balance sheets and make additions thereto or deductions therefrom, as may be required to arrive at the true taxable income. Both methods are illustrated in this solution.

The First Method

Profit as shown by the books.....		\$51,000
<i>Add:</i> Donations	\$8,000	
Income tax paid.....	70,000	
Interest disallowed.....	250	
Additions to Reserves.....	51,000	
Excess Depreciation.....	4,250	
Salary adjustment	1,000	134,500
		<hr/>
Total net income.....		\$185,500
<i>Less:</i> Dividend received.....	\$3,000	
Interest on Liberty Bonds.....	200	
Profit on Treasury Stock.....	2,000	
Profit on sale of Land.....	20,000	
Appreciation of Land.....	20,000	
Appreciation of Formula.....	1,000	46,200
		<hr/>
Net taxable income.....		\$139,300

The Second Method

Surplus Account December 31, 1918.....	\$139,100	
Surplus Allocations December 31, 1918.....	256,500	\$395,600
Surplus Account December 31, 1917.....	\$104,850	
Surplus Allocations December 31, 1917.....	205,500	310,350
Book profit for 1918.....		<u>\$85,250</u>

Additions:

Income tax paid.....	\$70,000	
Donations	8,000	
Disallowed interest (paid).....	250	
Salary prepaid.....	1,000	79,250
		<u>\$164,500</u>

Deductions:

Interest received on Liberty Bonds...	\$200	
Dividend received.....	3,000	
Profit on Treasury Stock.....	2,000	
Profit on sale of Land.....	20,000	25,200
Net taxable income.....		<u><u>\$139,300</u></u>

Reconciliation—Amended Balance Sheets

Taxable income.....		\$139,300
Other income—Profit on Land.....	\$20,000	
Profit on Treasury Stock....	2,000	
Dividend received.....	3,000	
Int. on Liberty Bonds.....	200	25,200
Total income.....		<u>\$164,500</u>
Less—Int. on Inadmissibles (paid).....	\$250	
Donations	8,000	
Income tax.....	70,000	
Additions to Reserves.....	51,000	
Salary Adjustment.....	1,000	130,250
Net addition to Surplus.....		<u><u>\$34,250</u></u>
Surplus December 31, 1918, <i>Amended</i>		\$139,100
Surplus December 31, 1917, <i>Amended</i>		104,850
Net addition to Surplus.....		<u><u>\$34,250</u></u>

Analysis of Capital Stock, Surplus and Reserves

Surplus as on books at December 31, 1917..	\$185,000
Net taxable income for the period.....	139,300
Capital Stock as shown on the books.....	300,000

\$624,300

<i>Less:</i> Disallowed Goodwill.....	\$59,000	
Treasury Stock.....	27,000	
Employees' Subscriptions.....	18,000	
Income tax paid.....	70,000	
Additions to Reserves.....	51,000	
Difference between book value and par value of Treasury Stock at begin- ning	3,000	
Interest paid on Inadmissibles.....	250	
Donations	8,000	
Depreciation to December 31, 1917...	24,150	260,400
		<hr/>
		\$363,900

<i>Add:</i> Stock paid for during the year.....	\$15,000	
Profit on sale of Land.....	20,000	
Profit on sale of Treasury Stock.....	2,000	
Difference between book value and par value of Treasury Stock at end of year.....	2,000	
Interest on Liberty Bonds.....	200	
Dividend received.....	3,000	42,200
		<hr/>

Total Cap. St. Surp. and Res. December 31, 1918.....	\$406,100
Less Capital Stock outstanding December 31, 1918.....	267,000

Surplus and Undivided Profits December 31, 1918.....\$139,100

Surplus and Undivided Profits as on Amended Balance Sheet, December 31, 1918.....	\$139,100
--	-----------

Note—Had Treasury Stock been deducted at par, but one adjustment of stock value would be required above—the \$2,000 adjustment.

Not an Unusual Balance Sheet

Lest you form the opinion that the original balance sheets presented in this problem are "far fetched" you are

assured that many with which auditors have to deal are more "scrambled" than this. The term "typical" properly captions this problem, in that each adjustment necessary is similar to adjustments required in every-day work of auditing returns. It is not intended to lead you to think that the average run of cases necessitates so many adjustments.

Goodwill for 1919

On the basis of stock outstanding at December 31, 1918, we should allow Goodwill in the amount of \$66,750 for 1919.

CHAPTER FIFTEEN

A GOOD PROBLEM

Note—The proposition that follows, together with its annotated solution, was used by the writer in his 1919 excess profits classes. It was the first involved problem based on 1918 tax law used for instruction purposes in the Unit. The class thought so well of it that a request was made of the Training Section that it be mimeographed for distribution, which request was denied. The class was determined to have it and raised a fund of about twenty dollars to have fifty copies mimeographed by persons in that business. Since then hundreds of copies have been made on the typewriter, and, of course, by this method of duplication, errors are sure to creep in.

Later, after certain changes had been made in the administration of the Training Section, many mimeographed copies were distributed. It is probable that this problem has been studied by more persons than all the other invested capital problems combined.

PROPOSITION No. 1

BALANCE SHEET

as at December 31, 1917

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$10,000	Accounts Payable.....	\$20,000
Treasury Stock.....	20,000	Bills Payable.....	22,000
Bills Receivable.....	15,000	Reserve for Unpaid Wages	1,000
Accounts Receivable....	18,000	Reserve for Bad Debts...	4,500
Inventory	110,000	Reserve for Depreciation.	40,000
Municipal Bonds.....	15,000	Reserve for Dividends....	100,000
Liberty Bonds.....	20,000	Reserve for Contingencies	1,000
Pullman Co. Bonds.....	17,000	Reserve for Federal Taxes	50,000
Swift and Co. Stock.....	30,000	Reserve for Accrued In-	
Plant	150,000	terest	1,500
Land and Buildings.....	75,000	Capital Stock	200,000
Goodwill	80,000	Surplus	80,000
		Undivided Profits.....	40,000
	<u>\$560,000</u>		<u>\$560,000</u>

The net earnings of the corporation were \$315,000. Dividends were paid as follows: February 20th, \$10,000; May 3rd, \$25,000; July 3rd, \$110,000. Goodwill, \$80,000, was paid in for cash and actually worth \$90,000.

Corporation received (July 10) dividends on Swift and Company Stock, amounting to \$2,500, and on September 1, the stock was sold at an advance of \$7,500 over cost. The municipal bonds were sold at cost August 1st, and one-half the proceeds were invested in National Bank Stock. October 1 the Treasury Stock was sold for \$24,000 and a commission of 1% was paid the Broker who handled the transaction.

(1) What is the invested capital for the calendar year 1918?

(2) If Goodwill had been worth but \$60,000 and had been paid for in stock of the corporation, would that affect your answer as to amount of invested capital?

Note—It is assumed that no changes, other than those mentioned, occurred during the year that would affect invested capital.

ANNOTATED SOLUTION

Swift and Co. Stock—

Statement: Holdings at the beginning of the year \$30,000; dividends received July 10, \$2,500. September 1 the entire block was sold at a profit of \$7,500.

Since income from stocks held in other corporations is not subject to excess profits tax, the amount so invested is not to be considered as an admissible asset.

But where a profit results from the sale of such inadmissibles a portion of the asset is restored to admissibles;

in the above case, this portion is the percentage that the profit bears to the total receipts from this source. Thus, we have—

Dividends	\$2,500
Profit	7,500
	<hr/>
Total receipts.....	<u>\$10,000</u>

The formula for arriving at the correct proportion (Art. 817) is—

Profits over total income by the amount of stock held—

$$\begin{array}{l}
 \frac{7,500}{10,000} \times \$30,000 = \$22,500 \text{ to be prorated over the period—} \\
 \text{January 1 to September 1, 243 days} \\
 22,500 \times \frac{243}{365} = \text{average amount of inadmissibles restored} \\
 \text{to admissibles.....} \quad \$14,979.45
 \end{array}$$

The proceeds of the sale become admissible from the date of sale until the end of the year, unless such proceeds have been reinvested in other inadmissibles, hence we have—

$$\begin{array}{l}
 \text{Proceeds of sale equals cost } \$30,000 \\
 \text{plus profit } 7,500 \\
 \text{-----} \\
 \$37,500 \text{ amount that be-} \\
 \text{comes admissible from September 1 to December 31 prorated} \\
 122 \\
 \$37,500 \times \frac{122}{365} = \text{.....} \$12,534.25 \\
 \text{Total conversion from inadmissibles to admissibles.....} \quad \underline{\underline{\$27,513.70}}
 \end{array}$$

There remains a certain amount of this stock still inadmissible, determined as follows:

Total holdings of Swift and Company stock.....	\$30,000
Amount converted by reason of sale.....	22,500
	<hr/>
Inadmissible portion.....	<u>\$7,500</u>

This amount remains inadmissible from January 1 to September 1, 243 days, and is prorated the same as the other portions of this asset:

$$\begin{array}{r} 243 \\ \$7,500 \times \frac{\quad}{365} = \$4,993.15 \end{array}$$

Entry on adjusted balance sheet:

Swift and Co. stock (admissible).....	\$27,513.70
(inadmissible).....	4,993.15
	<hr/>
Proof: Admissibles plus inadmissibles.....	\$32,506.85
Less the \$7,500 profit prorated on the basis of 122/365	
of a year.....	2,506.85
	<hr/>
Difference equals the original holdings.....	<u>\$30,000.00</u>

Had this stock been sold at a profit and had there been no dividends received or receivable, then the entire \$30,000 would have become admissible up to the date of the sale, and the entire proceeds would have become admissible after the date of the sale, provided, that the proceeds were not reinvested in other inadmissibles. (See Art. 817, last line but one.)

Or, had the sale been made without profit and the

proceeds of the sale had not been reinvested in other inadmissibles, then the entire \$30,000 would have remained inadmissible up to the date of the sale and the proceeds would have become admissible from the date of the sale until the end of the period.

Municipal Bonds

Statement: Total holdings \$15,000 all of which were sold August 1, at cost. One-half of the proceeds of the sale were at once reinvested in other inadmissibles.

This is an inadmissible item for the reason that the Federal Government may not tax income from obligations of the States nor the obligations of subdivisions of the States, and no asset (always excepting Liberty Bonds) the income from which may not be included in net income is to be considered as an admissible asset. The excess profits tax is, in large measure, dependent for its basis of computation on the amount of assets. It follows, therefore, that an asset that does not contribute to excess profits should not be a determining factor in the amount of those excess profits.

	153	
\$7,500x—=average or prorated amount which gives us—		
	365	
Admissible		\$3,143.84
The other half (not sold) gives us (averaged)——		
Inadmissible		\$3,143.84
From January 1 to August 1, or 212 days, the entire \$15,000 remained inadmissible, prorated—		
	212	
\$15,000x—=		8,712.32
	365	
Total average inadmissibles for the year.....		\$11,856.16
Proof: Admissible portion added to inadmissible portion equals the total holdings, or \$15,000.		

Treasury Stock

Statement: Stock, par value, \$20,000 sold October 1, for \$24,000.
Commission of 1% to brokers.

Gross receipts.....	\$24,000
Less 1%.....	240
	<hr/>
Net proceeds.....	\$23,760

This amount becomes an admissible asset for 92 days. (Art. 861.)

92
\$23,760x—=prorated addition to admissible assets. \$5,988.82.
365

Not only is this amount added to admissible assets, but the same amount must be added to invested capital. Had the same amount of outstanding stock been bought in, the \$5,988.82 would have to be deducted from admissible assets. Also, it would have to be deducted from invested capital unless it was purchased out of current earnings. See Art. 862, 4th line from bottom. But no earnings would be available until provision had been made for accrued income tax and to take care of any dividends that may have been declared.

Treasury Stock, like disallowed goodwill, is to be regarded neither as an admissible nor as an inadmissible asset. Both are eliminated from the adjusted balance sheet. Treasury Stock purchased by corporation reduces invested capital by the amount paid, regardless of the amount for which it was originally sold.

The first line in the preceding paragraph concerning the status of Treasury Stock was a bold one to make at that time (1919), being made after failure to get any one of five presumed-to-be eminent authorities to commit themselves on the subject (only five were consulted) and in the face of positive statements to the contrary appearing in

a book on income tax procedure by a very deservedly eminent author. This statement, as well as many others made has stood the test of time.

Dividends

Statement: Net earnings were \$315,000. Dividends declared as follows: February 20, \$10,000; May 3, \$25,000; July 3, \$110,000.

Before any dividends may be declared out of current earnings provision must be made for the income and profits taxes that have accrued during the taxable year. See Art. 857, (2), (a).

It is impossible, arithmetically, to determine the correct amount of taxes until we have determined the amount of invested capital. Also, it is impossible to determine, arithmetically, the invested capital, in case of its impairment by dividends, until the amount of tax is known.

Until such time as we are furnished an algebraic formula for solving this portion of the problem, we can only approximate the accrual of taxes in this manner: Compute the invested capital under the hypothesis that current earnings are sufficient to cover the tax and the dividends. Then use that amount in determining the sufficiency or insufficiency of the earnings to take care of both taxes (accrued) and the dividends. If the earnings are sufficient, the amount of invested capital you based your computation on is correct. If the earnings are not sufficient, adjust the presumptive invested capital accordingly and recompute the tax on the basis of the adjusted amount of invested capital to arrive at the amount of tax for the taxable year. See Art. 857. (2), 7th line from bottom.

Observe, however, that this method has no bearing on the adjustment to invested capital by reason of income tax paid during the taxable year for the previous year.

With the problem before us, having no prewar or other data necessary to the correct determination of the tax, we will assume that the amount of tax paid during the taxable year for the previous year is just the amount set up in the balance sheet, \$50,000. Also, we shall assume that the tax for the taxable year is \$90,000.

Now, since no funds are available for dividends until provision is made for accrued taxes, it is evident that the amount available is the net taxable income, less the accrual of income tax, hence we get the formula:

Net taxable income.....	\$315,000
Less the tax.....	90,000

Available for dividends.....\$225,000 divided
by 365=\$616.44 average daily earnings available.

Had there been a deficit at the beginning of taxable year, such deficit would have to be made good from the net \$225,000 before arriving at the daily average earnings available for dividends. Assume, for the moment, that a deficit did exist amounting to \$112,500. In such event the available daily earnings would be reduced to \$308.22. See Art. 838.

Since the \$10,000 dividend was payable during the first sixty days of the period, the entire amount of the dividend, prorated as of the date payable must be deducted from invested capital.

$$\begin{array}{r} 315 \\ \$10,000 \times \frac{\quad}{365} = \text{-----} \$8,630.11 \end{array}$$

The earnings up to May 3 were greater than the \$25,000 dividend, hence no adjustment is required.

Brought forward..... \$8,630.11

At the time of the payment of the \$110,000 dividend, July 3, the available earnings amounted to \$616.44x183 days, or a total earnings amounting to \$112,808.52. Since a dividend amounting to \$25,000 had previously been paid, it must be deducted from this amount of earnings, hence—

Earnings to July 3.....	\$112,808.52
Less dividend paid May 3.....	25,000.00

Available for July dividend.....	\$87,808.52
Amount of July dividend.....	110,000.00

Decrease of invested capital July 3.....	\$22,191.48
July 3 to December 31, 182 days, prorated—	

182

\$22,191.48x—=average decrease.....	\$11,065.34
-------------------------------------	-------------

365

Total reduction of invested capital caused by dividends	19,695.45
---	-----------

Income and excess profits taxes paid for the previous year, at June 15:
200

\$50,000x—=amount deducted from invested capital.....	\$27,397.26
---	-------------

365

We now come to the matter of the adjusted balance sheet. We wish to determine the percentage of deduction from invested capital by reason of the inadmissibles held. (See Art. 852.) For this purpose we shall cling to the assets side only. We shall have to see the balance sheet, assets side, not only at the beginning of the year, but at the end of the year and in this respect the assets side receives different treatment from that given the liabilities side, for with the latter we are concerned only with what we find at the beginning of the year. No consideration is given to the liabilities side of the sheet at the end of the

year. Were we to do so, it might in effect be capitalization of current earnings, where it is not permissible.

What we want is the average inadmissibles held throughout the year, and the average admissibles plus the inadmissibles held throughout the year. (Art. 854.) We take for the invested capital items the amounts appearing at the beginning of the year only, and adjust them by adding or subtracting according as additional capital (not earnings) has gone into the business or has been taken from the business.

We will assume that the net earnings, less dividends paid, were reflected in additions to plant at the end of the year. It is immaterial where we place them or how we distribute them over the asset items—the result will be the same. Cash has been increased by the net amount received from the sale of Treasury Stock—prorated, as well as by the profit made on the sale of Swift and Company's stock.

ASSETS—COMPARATIVE

	Jan. 1	Dec. 31	Average
Cash	\$10,000.00	\$36,260.00	\$17,187.45
Treasury stock.....	20,000.00	.....	.....
Bills receivable.....	15,000.00	15,000.00	15,000.00
Accounts receivable.....	18,000.00	18,000.00	18,000.00
Inventory	110,000.00	110,000.00	110,000.00
Municipal bonds—Admissible ...	.....	.....	3,143.84
Inadmissible ..	15,000.00	.....	8,712.33
National Bank stock.....	.....	7,500.00	3,143.84
Pullman Company bonds.....	17,000.00	17,000.00	17,000.00
Swift and Co. stock—Admissible .	.....	.....	27,513.70
Inadmissible	30,000.00	.....	4,993.15
Liberty bonds.....	20,000.00	20,000.00	20,000.00
Plant	150,000.00	262,500.00	206,250.00
Land and Buildings.....	75,000.00	75,000.00	75,000.00
Goodwill	80,000.00	80,000.00	80,000.00
	<u>\$560,000.00</u>	<u>\$641,260.00</u>	<u>\$605,944.31</u>

Goodwill, having been paid for in cash, is allowable to the full amount. The answer to Question Two is: Goodwill would be allowable to the extent of 25% of the outstanding capital stock which was \$180,000; that is \$200,000 less the \$20,000 Treasury Stock, or a total Goodwill allowance of \$45,000.

The profit on the sale of Treasury stock, not being subject to the tax (see Art. 542) and not being included in the \$315,000 net income, is reflected in the asset cash, as is also the \$2,500 dividends received on the Swift stock, inasmuch as these items of income went into the active assets as at the date received.

Note that the additions to assets through the sale of inadmissibles are prorated as at the date they became a part of the admissible assets, while the net profits for the year are averaged as having been a constant accrual.

Analysis of cash as at December 31:

On hand.....	\$10,000
From sale of Treasury Stock.....	23,760
Dividend received.....	2,500
	<hr/>
Total.....	<u>\$36,260</u>

Analysis of cash averaged:

On hand.....	\$10,000.00
Prorated amount of dividend received (2,500).....	1,193.63
Prorated amount of Treasury stock sold (23,760).....	5,988.82
	<hr/>
Total	<u>\$17,187.45</u>

Analysis of averaged plant account:

At beginning			\$150,000.00
Profits	\$315,000.00		
Less dividends paid.....	\$145,000.00		
Less stock profit.....	7,500.00		
Less taxes paid.....	50,000.00	202,500.00	112,500.00
Plant at December 31.....			<u>\$262,500.00</u>

Plant at beginning of the year.....	\$150,000.00
Plant at end of year.....	262,500.00

2) 412,500.00

Averaged amount.....\$206,250.00

The profit on the sale of Swift and Company stock is taken out of the net profits above for the reason that this item already has been included in the assets at the end of the year through the averaging of the amount of this inadmissible item restored to admissibles.

The next thing to be considered is: What are the invested capital items? For the answer we must turn to the liabilities side of the balance sheet at the beginning of the year. See Art. 854, 6th line. We find on our balance sheet—

Reserve for bad debts.....	\$4,500.00
Reserve for dividends.....	100,000.00
Reserve for contingencies.....	1,000.00
Reserve for Federal taxes.....	50,000.00
Capital stock.....	\$200,000.00
Less Treasury stock.....	20,000.00
Surplus	80,000.00
Undivided profits.....	40,000.00
Total.....	<u>\$455,500.00</u>

Deductions:

Prorated income tax paid.....	\$27,397.26	
Impairment by dividends.....	19,695.45	47,092.71
		<hr/>
		\$408,407.29

Addition:

Prorated amount of treasury stock sold.....	5,988.82	
		<hr/>
Potential invested capital.....	\$414,396.11	<hr/>

Reserves for unpaid wages and accrued interest are not true reserves, and should not be set up as such, though we sometimes see it done that way. They are deferred liabilities and stand on a par with accounts payable.

The amount stated as potential invested capital would be the actual amount of invested capital had the taxpayer carried no inadmissible assets during the year. Since the taxpayer did carry inadmissibles we must reduce this potential amount by the percentage that the average of inadmissibles bears to the total of admissibles and inadmissibles, and it was to obtain the basis for this computation that all the work of averaging to obtain the average asset column of assets was done.

But before we proceed with this computation we have one thing further to consider, and that is: Does our averaged-asset column reflect the true value of the assets? See Art. 852, 9th line from bottom. To find out we must look into the matter of depreciation. It is a matter often and easily overlooked. In this instance we find on the liabilities side the entry:

Reserve for depreciation -----\$40,000

We shall assume that this is the correct amount. If it were not, we should have to determine what is the correct amount and add to or take from the total assets according as the amount was found to be too small or too large.

This matter of depreciation is especially easily overlooked when set up in a balance sheet as it is set up in the one we are considering. Were it set up as shown below, it were more readily and unconsciously taken into consideration:

Plant	\$150,000	
Less Reserve.....	40,000	\$110,000
		<hr/>

In such case you see it already would have been deducted, and that is what we must now do—

Assets as determined.....	\$605,944.31
Less depreciation.....	40,000.00
	<hr/>
Net assets.....	<u>\$565,944.31</u>

Of this amount, \$16,849.32 are inadmissible, and to find the net deduction from the potential invested capital we use the formula:

$$\begin{array}{r}
 \$16,849.32 \\
 \hline
 \text{---} \times \$414,396.11 = \$12,337.42, \text{ the amount to be deducted} \\
 565,944.31 \\
 \text{from } \$414,396.11, \text{ leaving a true invested capital amounting to} \\
 \$402,058.69.
 \end{array}$$

In one respect our depreciation deduction is, perhaps, not quite correct. We have deducted the \$40,000 as set up on the books at the beginning of the year. During the year depreciation would take place and whatever the amount

should be, it should be reflected in the assets at the end of the year. It would be worked out this way:

Depreciation reserve at beginning of year.....	\$40,000
Depreciation reserve at end of year.....	44,000
	<hr/>
	2) 84,000
	<hr/>

To be deducted from the averaged Balance Sheet. \$42,000

On the assumption that the net profit of \$315,000 is based on sufficient depreciation having been charged off at the end of the year, in other words, that the net assets were increased by this amount, net, then the problem as worked is correct. Had the problem been made up of two complete balance sheets as at the beginning and as at the end of the year, there could have remained no question as to how much or how little depreciation to deduct from assets.

Do not lose sight of the fact that while the matter of depreciation that takes place during the year might be considered not only in determining the average assets held during the year, but also in arriving at the true net income, such depreciation has no bearing on invested capital as of the beginning of the year, and no adjustments are to be made to invested capital by reason of depreciation taking place during the taxable year.

Had no reserve for depreciation been set up, not only would the assets have to be reduced by the amount of depreciation, but the surplus also would have to be reduced.

In computing the amount of tax for the taxable year any dividends paid during the first sixty days, as well as any other evident impairment of capital or surplus should be adjusted before making the computation. In other

words, aim to arrive as nearly as may be possible at the correct amount of invested capital before determining the amount of accrued taxes.

In case you were considering a balance sheet having no entries on the liabilities side but invested capital items, but with inadmissibles on the assets side, the formula for ascertaining the percentage of inadmissibles to total of admissibles and inadmissibles need not be followed. Simply deduct the inadmissibles from your invested capital. The result will be exactly the same as it would be were you to follow the percentage formula.

CHAPTER SIXTEEN

QUIZZER NUMBER ONE

Applying to Chapter Seven

In computing invested capital in the following ignore any adjustments that are not required by the explanations.

1. The Balance Sheet of the Green Marble Company as at January 1, 1918, is as follows:

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$10,000	Accounts Payable.....	\$40,000
Receivables	140,000	Capital Stock	200,000
Inventory	30,000	Surplus	80,000
Plant	120,000		
Treasury Stock.....	20,000		
	<u>\$320,000</u>		<u>\$320,000</u>

The corporation was organized January 1, 1915, taking over the plant of A. J. Green & Company, valued at \$100,000 and for which stock was issued in a like amount.

Owing to changed conditions due to the war, it was necessary to carry more long-time open accounts than the working capital justified and the concern found itself cramped for ready cash. To overcome this handicap, A. J. Green returned to the corporation, October 10, 1917, stock amounting to \$40,000, with the stipulation that none of it should be resold for less than par value—\$100. Since Mr. Green was the owner of 95 per cent of the capital stock of the corporation, he regarded it merely as taking money

out of one pocket and putting it in another—both pockets being his.

Of the stock returned, \$20,000 was sold, December 12, 1917, for cash, at par, and the remaining \$20,000 was sold June 10, 1918, at 105. The stock not accounted for in these explanations was issued for cash, at par, prior to 1917.

Required: The invested capital for 1918.

2. (a) The A. C. James Company, composed of A. C. James, John James, and Henry James, was organized December 30, 1917, with an authorized capital stock of \$300,000, par value \$100.

A. C. James subscribed for 1,250 shares, John James for 825 shares, and Henry James for 825 shares, all of which was paid for in cash, at par value. In addition, they turned over to the corporation a plant fairly worth \$20,000.

On the basis of the above information, set up a balance sheet (based on income tax procedure) as at January 1, 1918, and compute invested capital for 1918.

(b) At December 31, 1918, John James decided to retire from the business. He transferred, as gifts, 200 shares to A. C. James, and 200 shares to Henry James. He sold to Frank Allen 200 shares for \$26,000 cash. The remainder of his holdings he turned in to the corporation as Treasury Stock, without compensation at the time, merely stipulating that the corporation should pay him par value for it at such time as in the opinion of the Board of Directors, the corporation was financially strong enough to do so. This stock was entered on the books as an asset at par value. A reserve (charged to surplus) was set up to cover this item.

During the year net profits amounted to \$20,000, all of which were invested in additional plant facilities.

On the basis of the above information, construct balance sheet (based on income tax procedure) as at January 1, 1919, and compute invested capital for 1919.

(c) March 7, 1920, A. C. James became "hard up" by reason of unfortunate deals in the stock market and sold to Frank Allen 400 shares of his stock at \$90 a share and to Henry James he sold 200 shares at \$80 a share.

On April 10, 1920, the corporation disposed of the Treasury Stock at \$110 a share, taking in payment therefor a lot of iron castings that could be profitably used in the business. Later an inventory of the castings was made, disclosing the fact that they were actually worth, at fair market price, \$27,750, and it was found that one-third of them would not be of use during the year 1920. In fact, it was necessary to put them in storage to be used at some indeterminate future date.

During the taxable year 1920 the concern made a net profit of \$36,000, all of which was paid out in dividends, December, 1920.

Using the above information as a basis, set up a balance sheet (based on income tax procedure) as at January 1, 1920, and compute invested capital for 1920.

QUIZZER NUMBER TWO

Applying to Chapter Eight

1. Inasmuch as a Reserve for Bad Debts is not a deductible item, it must be included in invested capital. Note the different ways of setting up a balance sheet:

<i>Assets</i>		<i>Liabilities and Capital</i>	
(a) Miscellaneous A s -		Capital Stock	\$75,000
sets	\$100,000	Notes Payable	25,000
Accounts Receivable ..	12,000	Surplus	20,000
Notes Receivable ...	8,000		
	<u>\$120,000</u>		<u>\$120,000</u>

(b) Miscellaneous A s -			
sets	\$100,000		
Receivable ..	\$20,000		
Less Doubt- ful Ac- counts ..	5,000	15,000	
	<u>\$115,000</u>		<u>\$115,000</u>

(c) Miscellaneous A s -		Capital Stock	\$75,000
sets	\$100,000	Notes Payable	25,000
Accounts Receivable	12,000	Reserve for Bad Debts...	5,000
Notes Receivable ...	8,000	Surplus	15,000
	<u>\$120,000</u>		<u>\$120,000</u>

Brought down.....	\$148,000
Machinery four years by 5% by \$30,000 gives \$6,000 as the true depreciation. Excess depreciation (added).....	4,000
	<u>\$152,000</u>
Buildings ten years by 2½% by \$40,000 gives \$10,000 as the true depreciation. Insufficient depreciation (to be deducted)	8,000
	<u>8,000</u>
Invested capital.....	<u><u>\$144,000</u></u>

Suppose the balance sheet were thus—

Miscellaneous A s -	Capital Stock.....	\$100,000
sets \$100,000	Accounts Payable.....	10,000
Machinery 30,000	Reserve for Federal	
Buildings ... 40,000	Taxes	10,000
	Reserve for Depreciation	12,000
	Surplus	38,000
	<u>\$170,000</u>	<u>\$170,000</u>

Invested capital is Capital Stock plus Reserve for Federal Taxes plus Surplus, or a total of \$148,000 apparently. BUT, since the reserve is not sufficient to cover the depreciation, we must reduce this amount by the insufficiency of the Reserve, which is \$4,000 as shown in the first depreciation computations, leaving an invested capital of \$144,000.

Note that the Reserve for Federal Taxes is included in invested capital. Inasmuch as this is due and payable June 15, it is evident that it will be out of the business for 200 days, hence—

\$10,000x200/365 is \$5,479.45 which amount must be deducted from \$144,000 leaving a net invested capital of \$138,520.55.

\$75,000 more than it cost. Deducting this from \$297,000 leaves \$222,000. To this we must add the receipts (pro-rated) from the sale of Treasury Stock: $\$36,000 \times 220/365 = \$21,698.63$ plus \$222,000 gives a net invested capital of \$243,698.63.

If the real estate (land) had been carried at less than cost we should add back the difference between the value at which it is carried and the cost price.

Treasury Stock Problem

Miscellaneous Assets.....	\$50,000	Capital Stock.....	\$150,000
Plant (acquired by		Notes Payable.....	25,000
stock)	150,000	Surplus	25,000
Treasury Stock.....	30,000		
	<u>\$230,000</u>		<u>\$230,000</u>

First Assumption—

Plant acquired for stock of the corporation at par. Treasury Stock returned to the corporation at a nominal sum.

Invested capital is—

Capital Stock less Treasury Stock.....	\$120,000
Plus Surplus, BUT, inasmuch as the Treasury Stock was reacquired at a nominal sum, it is assumed that the plant was worth only the par value of the stock retained by the donor, hence Surplus must be reduced by this inflated value; that is, \$55,000 minus \$30,000.....	25,000

Invested capital \$145,000

Second Assumption—

Plant acquired for cash or for stock at par and it is conceded that the plant was worth this amount. Treasury Stock purchased at par.

Invested capital is—

Capital Stock less Treasury Stock.....	\$120,000
Plus Surplus.....	55,000
	<hr/>
Invested capital	<u>\$175,000</u>

It seems well again to point out the fact that Treasury Stock is not an asset and that the foregoing balance sheet does not conform to correct technique. If it were presented as below (the only correct way of showing Treasury Stock) the real invested capital would be more readily apparent.

<i>Assets</i>		<i>Liabilities and Capital</i>	
Miscellaneous Assets.....	\$50,000	Notes Payable.....	\$25,000
Plant (acquired by stock		Capital Stock...\$150,000	
issue)	150,000	Less Treasury	
		Stock	30,000 120,000
		Earned Surplus.	55,000
	<hr/>		<hr/>
	\$200,000		\$200,000
	<hr/>		<hr/>

Stock outstanding (\$120,000), plus Surplus (\$55,000) equal invested capital (\$175,000).

Now Test Your Knowledge

BALANCE SHEET

THE MOLINE LINSEED OIL COMPANY

as at December 31, 1918

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$20,000	Accounts Payable.....	\$35,000
Notes Receivable	19,000	Reserve for Amortization	
Accounts Receivable	11,000	of Goodwill	11,000
Inventory	95,000	Customers' Reserve.....	20,000
Plant	300,000	Allowance for Deprecia-	
Goodwill	55,000	tion (O. K.)	31,000
Treasury Stock (bought		Capital Stock	300,000
at par)	10,000	Surplus	113,000
	<u>\$510,000</u>		<u>\$510,000</u>

In taking inventory the corporation realized that nearly everything in its line was taking an upward trend, hence, it valued everything at market if that was higher than cost, or at cost, if the market of that particular item had declined, for it was believed that the trifling declines were but temporary, and such they later proved to be. The total variation amounted to \$7,000.

During 1918, to induce certain good customers to purchase oil in large quantities the company agreed that if the price, during 1919, should average five per centum (or more) less than the price the customer paid for the oil, it would return to the customer the difference between the price he paid for the oil and the average price at which the oil could have been purchased during 1919. Late 1919 it appeared that not only would the corporation have to refund the amount of the reserve, but perhaps a greater amount.

At December 31, 1918, it was decided to set up a Reserve for Amortization of Goodwill over a period of five years. The matter of Goodwill not yet being presented to you in text form, it is but fair to state that the amount carried, \$55,000, would be permissibly reflected in invested capital. The Reserve for this purpose was a charge to Surplus. All stock was issued at par value for cash or its equivalent.

Required: Invested capital for 1919.

QUIZZER NUMBER THREE

Applying to Chapter Nine

BALANCE SHEET

SAXON CHEMICAL COMPANY

December 31, 1917

(1)	<i>Assets</i>	<i>Liabilities and Capital</i>
Cash	\$25,000	Capital Stock .....\$300,000
Plant	160,000	Accounts Payable..... 90,000
Real Estate.....	100,000	Reserve for Bad Debts.. 15,000
Patent	15,000	Reserve for Federal
Formulae (a).....	20,000	Taxes 50,000
Formula (b).....	10,000	Reserve for Depreciation 40,000
Treasury Stock.....	70,000	Reserve for Contingen-
Goodwill	100,000	cies 65,000
Miscellaneous Assets.....	200,000	Undivided Profits..... 35,000
		Surplus 105,000
	<u>\$700,000</u>	<u>\$700,000</u>

Note—The technician would object to this arrangement of the balance sheet, but it suits our purpose best this way.

History of the Case

The corporation was organized January 1, 1914, at which time Capital Stock was issued for property as follows:

Plant	\$160,000
Patent	15,000
Formulae (a).....	20,000
Goodwill	65,000
Cash	40,000
Total.....	<u>\$300,000</u>

The Treasury Stock was acquired by the corporation in December, 1917, for cash and other property, at par.

The patent is very valuable and the corporation requests permission to revalue it and to have the actual value (\$57,000) reflected in Surplus. It has never charged off any depreciation on the patent.

Formula (b) was purchased for cash.

It has been definitely ascertained that the Goodwill was actually worth much more than it cost, based on par value of the stock issued therefor, probably as much as \$250,000, but the company wishes to be conservative and carries it at \$100,000.

During the taxable year \$19,000 was charged off for Bad Debts. Income tax for 1917 amounting to \$18,250 was paid March 15, 1918.

The amount of Reserve for Depreciation seems to be correct up to the date of this balance sheet, but during the taxable year, it appears that \$3,000 too much was charged off.

(Owing to lack of space, the balance sheet as at December 31, 1918, is not presented, but it is found that at June 12, 1918, the concern obtained permission to increase Capital Stock to \$400,000, which was that day issued for property as follows:

Tangible property.....	\$60,000
Intangible property.....	20,000
Notes	20,000

The notes were given by one of the original stockholders, the company discounted them at the bank, having \$19,000 placed to its credit as a result.)

February 3, 1918, a dividend in the amount of \$16,000

was declared. The earnings up to this date amounted to \$12,500.

A close scrutiny of the expense account reveals that in May, 1918, the company installed a new series of chemical tanks, at a total cost of \$12,300. Of this amount, \$1,050 was for the services of an engineer for mapping locations, etc., and \$2,140 was for services and materials necessary to prepare the tank locations. All of this \$12,300 was charged to expense. It also developed that during 1917 a number of oxygen containers were installed, at a total cost of \$18,750. Of this amount, \$14,000 was for the containers, \$2,750 was for new piping and connections incident to the installation of the containers. The balance was for labor. All of these items were charged to expense.

On August 4, 1918, \$50,000 of the Treasury Stock was sold for \$48,000 cash.

On August 11, 1918, one of formulae (a) was sold for \$10,000 cash. Originally this group consisted of three formulae, all being considered of equal value.
Required: The invested capital for 1918.

(2) In 1913 the Horton Company earned above all dividends and other disbursements, \$9,000. In 1914 it lost \$3,000 by reason of having to pay higher prices for materials to fulfill contracts entered into in 1913. In 1915 it earned a large sum, all of which was credited to Surplus. In 1916 it lost all it earned in 1915 and \$6,000 additional. In 1917 it earned \$38,000 and declared a dividend of \$20,000. During these periods its Capital Stock was \$200,000. Ignore any statutory adjustment not called for by these explanations. What is the invested capital for 1918?

QUIZZER NUMBER FOUR

Applying to Chapter Ten

BALANCE SHEET

THE STANDARD MACHINE COMPANY

December 31, 1917

(1)	<i>Assets</i>	<i>Liabilities and Capital</i>	
Cash	\$82,000	Accounts Payable.....\$27,000	
Receivables	33,000	Bonds (20 year).....100,000	
Plant	150,000	Reserve for Federal Taxes 18,250	
Bond Fund.....	25,000	Funded Reserve..... 25,000	
Edison Company Bonds..	20,000	Capital Stock.....150,000	
Copper Stocks.....	15,000	Surplus	54,750
Western Union Telegraph Stock	10,000		
Goodwill	40,000		
	<hr/>		<hr/>
	\$375,000		\$375,000

History

Organized January, 1913, taking over the business of W. B. Moses & Company. The stockholders of the corporation had been the partners in the concern taken over. The plant had a life of 25 years after acquisition and was worth \$212,000, but it was acquired for stock amounting to \$150,000 and carried on the books at that figure. The Goodwill attaching to the corporation was worth \$40,000. No Paid-in-Surplus was set up on excess value of plant. Income tax paid in 1918 for 1917 was \$18,250.

May 1, 1918, the Edison bonds were sold for \$22,000 and interest amounting to \$600 was received on them at about the same date.

September 10, the W. U. Stock was sold at a profit of \$500. No other income was received from this source.

The copper stocks were sold October 3 for \$20,000, which amount included an available, but unpaid dividend of 10 per cent. Receipts from inadmissibles were not reinvested in inadmissibles.

A dividend of \$30,000 was declared and payable March 12, 1918. Earnings up to this date amounted to \$40,000, plus the accrued income and profits taxes.

No depreciation has been charged off, the corporation contending that the usual repairs are sufficient to continue the plant at 100 per cent value.

Assuming that the total assets at December 31, 1918, amounted to \$410,000, and that this amount is the result of adjustments based on invested capital procedure, what is the invested capital for 1918?

In 1908 the Cutler Company acquired a patent in exchange for stock, par value, \$100, amounting to \$30,000. During 1910-11-12 the patent was greatly improved, and all the costs of development were consistently charged to Expense. These amounts aggregated \$28,165.

During 1914 and 1915 further improvements were made at a total cost of \$17,520 all of which were entered on the books as charges to Surplus. At March 1, 1913, the patent was revalued at \$74,000, but the revaluation was not set up on the books.

The capital stock outstanding March 3, 1917, was \$50,000. During 1917 additional stock, amounting to \$150,000 was issued at par, for cash. The Balance Sheets (condensed) for 1918 are as follows:

<i>Assets:</i>	<i>December 31, 1917</i>	<i>December 31, 1918</i>
Cash	\$10,000	\$35,000
Plant	135,000	140,000
Patent	30,000	30,000
Standard Oil Stock.....	.....	25,000
Miscellaneous Tangibles	80,000	110,000
Goodwill	45,685	45,685
	<u>\$300,685</u>	<u>\$385,685</u>

The Oil Stocks were purchased December 2, 1918. The Goodwill was set up in 1917 and represents the amounts expended for development of patents. Just how the book entries were made is not essential to this problem.

Income Tax paid in 1918 for 1917 was \$35,000.

<i>Liabilities:</i>		
Capital Stock.....	\$200,000	\$200,000
Income Tax Reserve.....	35,000	35,000
Surplus Allocations	20,000	30,000
Surplus	45,685	120,685
	<u>\$300,685</u>	<u>\$385,685</u>

Required: Invested Capital for 1918.

QUIZZER NUMBER FIVE

Applying to Chapter Eleven

1. Part-year Proposition—

The Union Hardware Company has been filing its return on the fiscal year basis, as at April 30. It is decided to file future returns on the calendar year basis, and a return is filed for the eight-month period ended December 31, 1918.

The net income for the taxable period is \$100,000; invested capital, \$125,000. The net income for the pre-war period averaged \$30,000; average pre-war invested capital, \$70,000.

Assume that income tax for the fiscal year May 1, 1917, to April 30, 1918, was \$24,500. No dividends were paid that would affect invested capital.

Compute the income and profits taxes for the period.

2. A Mining Proposition—

During 1918 the Colorado Minerals Company was engaged in mining silver, lead, and gold, from which all of its income was derived.

In keeping records of the expenses applicable to any particular branch of the business items were not always charged to the proper account, but went into a "Miscellaneous Expense" account.

The gross receipts were \$3,100,000. Here, also the bookkeeping was faulty, inasmuch as all receipts were

credited to one general account without differentiation, but, since the value of all concentrates was credited to the Company upon the books of the milling company immediately after passing through process, it was possible to ascertain from the books at the mills, the proportionate amounts, making up the grand total. Those books reflected: Silver, \$875,000; Lead, \$965,000.

The mining company's books showed the following expense totals:

Gold	\$800,000
Silver	610,000
Lead	450,000
Miscellaneous expenses.....	620,000
	<hr/>
Total expenses.....	<u>\$2,480,000</u>

Consider all expense items allowable. Disregard the fact that inventories of unsmelted ore might change the result.

(a) What is the *total taxable income*? How would the tax be computed?

(b) Assume that the invested capital for 1918 was \$1,400,000; that the average pre-war invested capital was \$1,000,000; that the average pre-war net income was \$125,000. What is the total tax liability for 1918?

3. Part Government Contract Proposition—

An examination of the books of the Colby Company, Inc., manufacturers of furniture, educed the following:

Average pre-war invested capital, \$200,000. Average pre-war earnings, \$20,000.

July 18, 1917, the Company entered into a contract with the Government for the manufacture of cases for wireless apparatus. Gross income from this source \$150,000. Expenses attributable to this portion of the business, \$110,000.

August 3, 1917, the Company entered into a contract with the Standard Aircraft Corporation for the manufacture of wood parts for airplanes. The Standard Company had a Government contract to manufacture planes.

The Colby Company continued to manufacture their regular lines of furniture, the gross receipts from which were \$250,000. Expenses and losses attributable to furniture manufacturing were \$180,000.

The total gross income of the Colby Company was \$600,000. The total expenses were \$400,000, of which amount \$30,000 could not be attributed to any particular division of the business. It is assumed that the \$400,000 includes a reasonable amount for depreciation.

Condensed balance sheets follow:

<i>Assets:</i>	<i>December 31, 1918</i>	<i>December 31, 1919</i>
Cash	\$30,000	\$20,000
Accounts receivable.....	95,000	100,000
Inventory	70,000	80,000
Plant	105,000	110,000
Sundry assets.....	50,000	100,000
	<u>\$350,000</u>	<u>\$410,000</u>
 <i>Liabilities:</i>		
Notes payable	\$60,000	\$60,000
Capital Stock.....	250,000	250,000
Surplus	40,000	100,000
	<u>\$350,000</u>	<u>\$410,000</u>

No inadmissibles were carried at any time. Receipts from manufacturing is the only income. No goodwill set up.

October 10, 1919, the Company paid a dividend of \$100,000. The Federal taxes for 1918 were \$40,000.

Required: The income and profits taxes for the calendar year 1919.

GENERAL QUIZZER NUMBER SIX

Fiscal Year Proposition

THE HORTON MERCANTILE COMPANY

BALANCE SHEETS

<i>ASSETS</i>	<i>June 30, 1917</i>	<i>June 30, 1918</i>	<i>June 30, 1919</i>
Cash	\$18,000	\$23,000	\$46,000
Receivables	17,000	26,000	22,000
Inventory	80,000	96,000	102,000
Furniture and Fixtures.....	3,000	3,000	3,000
Patent	25,000	25,000	25,000
General Electric Stock.....	35,000	30,000	20,000
Atlas Cement Company Bonds. ....	.....	.....	10,000
Municipal Bonds.....	10,000	10,000	30,000
Store and Office Building.....	65,000	60,000	55,000
Deferred Charges.....	4,000	4,000	4,000
Bond Discount.....	10,000	9,000	8,000
Retirement Fund	5,000	10,000	15,000
Real Estate.....	20,000	20,000	20,000
Treasury Stock.....	30,000	30,000	.....
Goodwill	50,000	50,000	50,000
	<u>\$372,000</u>	<u>\$396,000</u>	<u>\$410,000</u>
 <i>LIABILITIES</i>			
Outstanding Bonds.....	\$50,000	50,000	50,000
Notes Payable.....	6,000	7,000	3,500
Depreciation Account.....	20,000	25,000	30,000
Reserve for Government Income			
Tax	30,000	30,000	30,000
Reserve for Bad Debts.....	1,500	2,000	2,000
Reserve for Contingencies.....	5,000	.....	4,000
Reserve for Depreciation of			
Patent	1,500	3,000	4,500
Surplus	58,000	79,000	86,000
Capital Stock	200,000	200,000	200,000
	<u>\$372,000</u>	<u>\$396,000</u>	<u>\$410,000</u>

Other facts—

- (a) Atlas Cement Company bonds were acquired February 1, 1919.
- (b) Municipal bonds, amounting to \$20,000 were purchased August 1, 1918.
- (c) Of the General Electric stock, \$5,000 was sold January 2, 1918, at cost, and \$10,000 was sold March 1, 1919, for \$11,000. On this stock no dividends were received until July 25, 1919, at which time according to the books, an 8% dividend was declared and paid.
- (d) All transfers or sales of stock were at once recorded on the books of the General Electric Company in the names of the purchasers.
- (e) The Retirement Fund was created in compliance with the terms of the contract entered into with the purchases of the outstanding bonds. These bonds were sold May 31, 1917, at a discount of 10%.
- (f) The Treasury stock was purchased at par, for cash. The lot was sold at par July 2, 1918.
- (g) Disregard the item of depreciation, except that the Depreciation Account is to be regarded as correct.
- (h) June 30, 1916, the corporation decided to amortize the patent by making, at the end of each year, beginning June 30, 1916, a charge to Surplus of \$1,500. The patent was acquired for stock.
- (i) Goodwill (in addition to the patent) was acquired for stock of the corporation at par value, but is regarded as being worth much more than the \$50,000 stock issued therefor. At the time of its

acquisition, the corporation had a bona fide offer of \$55,000 for this same block of stock, and the seller of the goodwill actually was offered, in cash, for the goodwill, the sum of \$50,000.

- (j) The remainder of the stock was issued for cash or tangible property at par value.
- (k) A dividend amounting to \$40,000 was paid July 5, each year. Available earnings exceeded the dividends.

Required: The invested capital for the fiscal years ended June 30, 1918, and June 30, 1919, and the total income taxes for the year ended June 30, 1919. Ignore any income tax that may have been paid or payable.

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